86 - 1307

Supreme Court, U.S.
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JOSEPH F. SPANIOL, JR.
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No.

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

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WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*
*Plaintiffs/Petitioners,*

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*
*Defendants,*

PEAT, MARWICK, MITCHELL & CO. and A. MARSHALL SNIPES
*Defendants/Respondents.*

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**ON WRIT OF CERTIORARI FROM THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT**

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**PETITION FOR WRIT OF CERTIORARI**

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## QUESTION PRESENTED FOR REVIEW

Can a duty of complete and truthful disclosure, sufficient to create liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, arise whenever a defendant voluntarily undertakes to provide information with an intent, knowledge, or awareness that the information will be communicated or disseminated to persons who will or may utilize it in connection with the purchase or sale of a security or does such a duty arise only when a fiduciary relationship or a similar relationship of trust or confidence between the parties is demonstrated?

## LIST OF ALL PARTIES

The following individuals and partnerships are the plaintiffs in the Court below:

WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP,
WINDON FOURTH OIL AND GAS DRILLING PARTNERSHIP,
WINDON FIFTH OIL AND GAS DRILLING PARTNERSHIP,
MARTIN G. BERGMAN,
EDGAR W. BRICK,
MILTON M. CAHN, M.D.,
JOSEPH L. DeSTAFANO, M.D.,
ARTHUR DINTENFASS, M.D.,
JOYCE EASTER, M.D.,
RICHARD FERGUSON,
DAVID L. FFRENCH,
FRANK. F. FURSTENBERG, JR.,
DR. FRANK F. FURSTENBERG, SR.,
HERMAN GITLOW,
BERNARD GITLOW,
ADELE GOLDBERG,
ROBERT K. GOLDEN,
ARTHUR P. GOLDENBERG,
BRIAN L. GRUBER,
LEE H. HUDSON,
HAROLD J. ISARD, M.D.,
ROBERT B. ISARD,
STUART A. JACKSON, ESQUIRE,
GEORGE H. JOHNSON, JR.,
STEVEN KAPUSTIN, ESQUIRE
LAWRENCE A. KERSON, M.D.,
JOHN W. KLOKEL,
LEONARD KOPLIN,
MITCHELL A. KRAMER, ESQUIRE,
PAUL B. KUPER,
DR. & MRS. G. CLAYTON KYLE,

MR. & MRS. ALTON G. LALIBERTE,
JAY B. LEONARD
RICHARD LEVINE
ROGER L. LEVY, ESQUIRE
DR. & MRS. ARNOLD MASTERS,
RALPH E. MCCULLOUGH,
WILLIAM MILGRAM,
RICHARD F. MURPHY
ROBERT P. OLSON,
PALLEY SIMON INVESTMENT PARTNERSHIP,
SAMUEL M. PALLEY,
PETER C. PAUL, ESQUIRE,
ERIC T. PHILIPPI,
LAWRENCE J. RAWSON,
EDITH REICH,
ESTATE OF JACOB REICH,
HERBERT T. RORER,
ARNOLD B. ROSENTHAL,
A. RICHARD ROSS,
MR. & MRS. LEONARD M. RUDY,
HERBERT W. SALUS, JR., ESQUIRE
GINO C. SEGRE,
ARTHUR A. SHAW, JR.,
ERIC W. SHAW, ESQUIRE,
HERBERT J. SIEGEL,
HOWARD SILVERMAN,
MAHLON B. SIMON, JR.,
SIDNEY SMALL,
JAMES F. SPANN, M.D.,
SAMUEL SURGARMAN, M.D.,
JOSEPH A. TOTINO, M.D.,
MR. & MRS. CURTIS V. TRINKO,
JOSEPH A. VARALLO, M.D.,
JAMES A. WEISS, ESQUIRE
DAVID A. WEST,
SUSAN Q. WEST,
BROOKS WHITEHOUSE,
AND
RUSSELL W. WHITMAN, ESQUIRE

The following are the defendants in plaintiffs' action:

FEDERAL DEPOSIT INSURANCE CORPORATION,
DEPOSIT INSURANCE NATIONAL BANK OF OKLAHOMA CITY,
BILL PATTERSON,
BILL P. JENNINGS,
ELDON L. BELLER,
PEAT, MARWICK, MITCHELL & CO.,
AND
A. MARSHALL SNIPES

Peat, Marwick, Mitchell & Co. and A. Marshall Snipes are Appellees in the Court below.

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*Windon Third Oil and Gas Drilling Partnership, et al., Plaintiffs v. Federal Deposit Insurance Corporation, Peat, Marwick, Mitchell & Co., A. Marshall Snipes, et al. Defendants,* No. CIV-83-536-E (W.D.Okla. April 25, 1985)

*Windon Third Oil and Gas Drilling Partnership, et al., Plaintiffs v. Federal Deposit Insurance Corporation, Peat, Marwick, Mitchell & Co., A. Marshall Snipes, et al. Defendants,* No. CIV-83-536-E (W.D.Okla. June 20, 1985)

*Windon Third Oil and Gas Drilling Partnership, et al., Plaintiffs v. Federal Deposit Insurance Corporation, Peat, Marwick, Mitchell & Co., A. Marshall Snipes, et al. Defendants,* No. CIV-83-536-E (W.D.Okla. May 19, 1986)

## STATEMENT OF GROUND ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

The jurisdiction of this Court is invoked pursuant to its discretionary authority to review a judgment granted under 28 U.S.C. § 1254(1).

The judgment sought to be reviewed was dated and entered November 10, 1986 in the United States Court of Appeals for the Tenth Circuit and is in conflict with decisions by the United States Courts of Appeals for the Fifth, Sixth, and Eleventh Circuits.

## STATUTES AND REGULATIONS WHICH THE CASE INVOLVES

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (L.Ed. 1983):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17b C.F.R. § 240.10b-5 (1979):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

IN THE

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OCTOBER TERM, 1986

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WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*
*Plaintiffs/Petitioners,*

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**ON WRIT OF CERTIORARI FROM THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT**

---

## PETITION FOR WRIT OF CERTIORARI

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## STATEMENT OF THE CASE

### Nature Of The Case

Petitioners seek review of the Tenth Circuit Court of Appeals' affirmance of the final Order filed April 25, 1985 by the United States District Court for the Western District of Oklahoma (the "April 25, 1985 Order") granting summary judgment on Counts V and VI of plaintiffs' Amended Complaint in favor of Peat, Marwick, Mitchell & Co. ("PMM") and A. Marshall Snipes ("Snipes") for plaintiffs' failure to state a

claim under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 and for lack of pendent jurisdiction over a related common law fraud claim. The United States District Court for the Western District of Oklahoma had subject matter jurisdiction over this matter pursuant to Section 27 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78aa and Sections 1331 and 1337 of the Judicial Code, 28 U.S.C. §§ 1331 and 1337 and under principles of pendent jurisdiction.

On June 20, 1985, an Order certifying the April 25, 1985 Order as a final judgment pursuant to Rule 54(b) of the Federal Rules of Civil Procedure was entered. On July 22, 1985, petitioners filed a Notice of Appeal and an appeal was taken to the Tenth Circuit Court of Appeals. On November 10, 1986, the Tenth Circuit Court of Appeals entered its opinion and order affirming the District Court's grant of summary judgment for Peat, Marwick, Mitchell & Co. and A. Marshall Snipes.

## Statement Of Facts

Plaintiffs are three Pennsylvania limited partnerships, Windon Third Oil and Gas Drilling Partnership, Windon Fourth Oil and Gas Drilling Partnership and Windon Fifth Oil and Gas Drilling Partnership (hereinafter collectively referred to as the "limited partnerships") and many of the limited partners of each limited partnership (the "limited partners").

On or about October 8, 1979, Robert P. Olson ("Olson"), a general partner in each of the limited partnerships, telephoned Snipes of the PMM office in Oklahoma City, Oklahoma. During the conversation, Olson indicated to Snipes he was a general partner of various Windon Oil and Gas Drilling Partnerships and that he was anticipating offering limited partnerships which would employ Clifford Resources, Inc. ("CRI") as the operator of wells for such partnerships and that the purpose of the conversation was to perform "due diligence" responsibilities with regard to CRI and its president Hal

Clifford. Further, during the course of the conversation, Olson informed Snipes that the limited partnerships would be purchasing interests in various oil and gas leases owned by CRI.

In such conversation, Snipes indicated to Olson that of the one hundred partnerships handled and/or examined by the PMM office in Oklahoma City, he and ten other PMM partners invested exclusively with CRI. Snipes further stated that the PMM Oklahoma City office invested its money with no one other than CRI. He further indicated that certain PMM partners had invested approximately $250,000.00 with Hal Clifford the principal of CRI personally. Finally, Snipes told Olson that CRI's oil reserves were worth several million dollars and that the cash flow was approximately $45,000.00 per month from these reserves.

The information provided by Snipes to Olson played a crucial role in the determination by the limited partnerships to retain CRI as the driller-operator for their oil and gas properties and was instrumental and critical to the general partners' decision to purchase interests in oil and gas leases from CRI on behalf of the limited partnerships. Further, CRI's retention was material to the decisions by the limited partners to invest in the limited partnerships.

The limited partnerships were subsequently formed and limited partnership interests sold during the period June, 1980 through December, 1981. The limited partnerships purchased interests in oil and gas leases from CRI.

At the time of his conversation with Olson, Snipes failed to disclose the existence of cash flow problems at CRI, although such problems were discussed in a memorandum dated September 18, 1979 which Snipes drafted and placed in PMM's correspondence file on CRI. Snipes did not disclose that he was the half owner of the J-M Joint Venture ("J-M"), an entity that borrowed money from Penn Square Bank to make a payment on a CRI loan from Penn Square.

Further, Snipes failed to disclose that the other half owner of J-M was Joe McEuen, president of Sterling Pipe and Supply ("Sterling Pipe") and a director of CRI. J-M invested in a retail housewares shop known as Applefields, along with a company known as Dimensions Group of which Hal Clifford, president of CRI, was vice-president. McEuen, Snipes, and Clifford were major shareholders and directors of Sterling Pipe, a company engaged in the sale of oil field production and drilling equipment. Snipes did not disclose that J-M had borrowed $150,000.00 from CRI to invest in oil field pipes.

Finally, Snipes failed to disclose that he had obtained three loans from Penn Square Bank totalling $600,000.00; that partners of PMM had obtained certain loans from Penn Square Bank; that these loans had been obtained with the aid and influence of CRI through CRI's dealings with Penn Square Bank; that CRI arranged for the bank to extend these loans so that Penn Square Bank would continue to make loans to CRI and those doing business with CRI; that PMM would gain additional fees from rendering accounting services to Penn Square Bank as its national reputation was enhanced; and that PMM partners in Oklahoma City, despite Snipes' representations, had invested in partnerships other than those run by CRI or Hal Clifford.

## ARGUMENT

### I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17b C.F.R. § 240.10b-5 make it unlawful to fail to disclose material information in connection with the purchase of securities. Such disclosures are required to "protect the basic integrity of the exchange markets." *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 756 (3d Cir. 1984). The Tenth Circuit Court of Appeals has rendered a decision which is contrary to this basic and important tenet of law. The Tenth Circuit has refused to recognize that a duty of full disclosure

arises whenever a defendant voluntarily undertakes to speak and has concluded that a duty of full disclosure arises only when a fiduciary or other relationship of truth and confidence exists. *Windon Third Oil and Gas Drilling Partnership v. Federal Deposit Insurance Corporation,* 805 F.2d 342, 347 (10th Cir. 1986).

The Tenth Circuit's position is contrary to the position taken by other Circuit Courts on the same issue, rejects settled principles of common law and represents an unnecessarily restrictive interpretation of *Chiarella v. United States,* 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980). Consequently, review on certiorari is warranted to resolve this divergence of opinion in a critical area of law.

The importance of this principle cannot be underestimated. If the Tenth Circuit's approach is upheld, there will be a class of defrauded securities purchasers deprived of a remedy. Particularly when buying securities in a private transaction, it is common for the seller to provide the potential purchaser with a reference from whom further information can be obtained concerning the seller, its reputation, and/or its securities. If a duty to completely and truthfully disclose material information, voluntarily provided with knowledge it will be utilized in connection with the purchase of securities, is not imposed on the individual contacted for a reference, there will be no remedy for the purchaser who relies upon information known to be untrue, incomplete, or misleading by the reference.

## II. THE TENTH CIRCUIT COURT OF APPEALS HAS RENDERED A DECISION WHICH IS IN CONFLICT WITH THE DECISIONS OF OTHER CIRCUIT COURTS OF APPEALS ON THE SAME MATTER

The Tenth Circuit Court of Appeals' rejection of the existence of a duty of full disclosure in the absence of a special relationship is contrary to the position taken by the Fifth, Sixth, and Eleventh Circuit Courts of Appeals.

The Fifth Circuit has recognized in cases of omissions, non-disclosures, and misrepresentations in the sale of securities the common law premise that once a party chooses to speak, he has an obligation "not only to state the truth, but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated; if he speaks at all, he must make a full and fair disclosure." *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1313 (5th Cir. 1977) *reh'g denied,* 564 F.2d 416 (1977), *cert. denied, Walter E. Heller & Co. v. First Virginia Bankshares,* 435 U.S. 952, 98 S.Ct. 1580, 55 L.Ed.2d 802 (1978). Although this decision predated *Chiarella,* the Fifth Circuit has not changed its position. *Upton v. Trinidad Petroleum Corp.,* 468 F.Supp. 330, 337 (N.D.Ala. 1979) *aff'd,* 652 F.2d 424 (5th Cir. 1981).

Circuit courts considering this issue after *Chiarella* have also recognized such a duty. The Sixth Circuit held that a party which has no prior duty assumes "the legal duty to be truthful" once it speaks. *Levinson v. Basic, Inc.,* 786 F.2d 741, 747, *appeal filed* (6th Cir. 1986). The Sixth Circuit quoted *First Virginia Bankshares* when it stated: "Under Rule 10b-5, '[a] duty to speak the full truth arises when a defendant undertakes to say anything.' " *Levinson,* 786 F.2d at 747. The Eleventh Circuit recently recognized that "a duty to disclose may also be created by a defendant's previous decision to speak voluntarily". *Rudolph v. Arthur Andersen & Co.,* 800 F.2d 1040, 1043 (11th Cir. 1986).

A significant number of District Courts in the Second, Third, Fourth, Seventh, and Eighth Circuits have followed *First Virginia Bankshares* to hold that "a party who makes a materially incomplete disclosure thereby triggers a duty under Rule 10b-5 to disclose whatever additional information is necessary to prevent the earlier statement from being misleading." *Rowe v. Maremont Corp.,* No. 77-C2837 (N.D.Ill. June 3, 1986) (A copy of this opinion appears in the Appendix, see pp. 54a-55a). *See, also, Grossman v. Waste Management, Inc.,* 589 F.Supp. 395, 409 (N.D.Ill. 1984); *Rose v. Arkansas Valley Environmental & Utility Authority,* 562 F.Supp. 1180, 1207-08 (W.D.Mo. 1983); *Marrero v. Banco DiRoma,* 487

F.Supp. 568, 575 (E.D.La. 1980); *Upton v. Trinidad Petroleum Corp.*, 468 F.Supp. 330 (N.D.Ala. 1979); *Issen v. GSC Enterprises, Inc.*, 538 F.Supp. 745, 751 (N.D.Ill. 1982); *Whitbread (US) Holdings, Inc. v. Baron Phillippe de Rothschild, S.A.*, 630 F.Supp. 972, 977 (S.D.N.Y. 1986); *City of Harrisburg v. Bradford Trust Co.*, 621 F.Supp. 463 (M.D.Pa. 1985); *Maryland National Bank v. Dauphin Deposit Bank*, 647 F.Supp. 908 (M.D.Pa. 1986); *Martin v. Pepsi-Cola Bottling Co.*, 639 F.Supp. 931 (D.Md. 1986); *Etshokin v. Texasgulf, Inc.*, 612 F.Supp. 1212, 1217 (D.C.Ill. 1984).

The duty which petitioners assert should be recognized was clearly articulated by the District Court for the Western District of Missouri:

> As concerns traditional liability under 10b-5, there are in reality several ways in which a 'duty' owed directly by a defendant to a plaintiff may come into being. The first, and most basic, of those situations exists whenever a defendant undertakes the affirmative act of communicating or disseminating information (which in this context refers to any form of communication or dissemination), with an intent, knowledge, or awareness, that the information will be communicated or disseminated to persons such as the plaintiff and will or may be utilized by them in connection with the purchase or sale of a security. There is in such instances obviously a general obligation, or 'duty' to speak truthfully; or alternatively stated, a 'duty' not to communicate something which is known to be untrue. . . And encompassed within that general obligation is also an obligation or 'duty' to communicate any additional or qualifying information, then known, the absence of which would render misleading that which was communicated.

*Rose v. Arkansas Valley Environmental and Utility Authority*, 562 F.Supp. 1180, 1206-1207 (W.D.Mo. 1983).

Petitioners clearly alleged that Olson made Snipes aware of the purpose of his contact with Snipes. Further, petitioners have alleged that Snipes voluntarily communicated information to Olson. In that context, it is clear that Snipes then had a "duty" to communicate any additional or qualifying information, then known, the absence of which would render misleading that which was communicated. This is precisely what petitioners have alleged Snipes failed to do. Snipes had available to him at the time of his conversation with Olson information reflecting adversely upon CRI, yet, did not disclose it. Having voluntarily agreed to discuss CRI with Olson, Snipes on behalf of PMM, had a duty to disclose the adverse information regarding CRI.

The facts of *First Virginia Bankshares* are strikingly similar to those presented by petitioners. A broker acting on behalf of a potential purchaser of a small consumer finance company was provided by the seller with several credit references including Heller, a commercial lending institution. The broker contacted Heller and was told that "their experience with Benson had been satisfactory for many years;" "more money could be made available to Benson;" the operation was characterized as "somewhat better than average" and "Benson has always met its obligations promptly." *First Virginia Bankshares*, 559 F.2d at 1311. Heller did not disclose that Benson was experiencing financial difficulties or any of the negatives concerning Benson. In reliance on the information provided by Heller, the plaintiffs purchased Benson. The Fifth Circuit affirmed the jury's finding that Heller was liable under Rule 10b-5 for failing to disclose the full truth about Benson. Despite the fact that Heller had "no pre-existing duty to disclose facts to the plaintiff, once it spoke, it had an obligation to speak the truth." *Whitbread (US) Holdings, Inc. v. Baron Phillippe de Rothschild, S.A.*, 630 F.Supp. 972, 978 (S.D.N.Y. 1986).

Likewise, Snipes voluntarily provided selected information to Olson which was then relied upon by petitioners. The decision to provide such information gave rise to a duty which Snipes and his employer breached because Snipes failed to make a full, complete, and truthful disclosure.

The Tenth Circuit's failure to recognize Snipes' and PMM's duty directly conflicts with the position taken by other Circuit Courts of Appeals and therefore review on certiorari is appropriate.

## III. A DUTY TO DISCLOSE WHEN A DEFENDANT UNDERTAKES TO SAY ANYTHING IS RECOGNIZED AT COMMON LAW AND IN THE LANGUAGE OF RULE 10b-5

The imposition of a duty of full disclosure when a defendant voluntarily undertakes to say anything is premised upon long-standing principles of the common law of fraud and deceit. *See Restatement (Second) of Torts* § 529 and Comment (a) thereto (1977); Prosser, *Law of Torts* § 106 (4th Ed. 1971). *Rose v. Arkansas Valley Environmental and Utility Authority,* 562 F.Supp. 1180, 1207 (W.D. Mo. 1983).

It is widely recognized that a party who might otherwise have no duty of disclosure is bound to disclose the full and complete truth once he chooses to speak. It is defendant's act of speaking at all which triggers the duty. *V.S.H. Realty, Inc. v. Texaco, Inc.,* 757 F.2d 411, 414 (1st Cir. 1985); *Consolidated Oil & Gas, Inc. v. Ryan,* 250 F.Supp. 600, 605 (W.D.Ark. 1966); *Southeastern Financial Corp. v. United Merchants & Manufacturers, Inc.,* 701 F.2d 565 (5th Cir. 1983).

The securities law concept that an affirmative duty to disclose exists is derived from the law of torts. *Issen v. GSC Enterprises, Inc.,* 538 F.Supp. 745, 751 (N.D.Ill. 1982), citing *Chiarella v. United States,* 445 U.S. at 228 n.9, 100 S.Ct. at 1114 n.9. Consequently, the duty of disclosure sought to be imposed which has its basis in tort law can be appropriately integrated into the law of securities.

Moreover, the rule rejected by the Tenth Circuit is explicit in the language of Rule 10b-5 itself which makes it "unlawful for any person . . . to omit to state a material fact necessary in order to make the statements made, in the light of the

circumstances under which they were made, not misleading . . . " *See, Rose v. Arkansas Valley Environmental & Utility Authority,* 562 F.Supp. 1180, 1207 (W.D. Mo. 1983).

## IV. THE TENTH CIRCUIT COURT OF APPEALS HAS ADOPTED AN UNNECESSARILY RESTRICTIVE INTERPRETATION OF A DECISION OF THIS COURT

The Tenth Circuit's rejection of a duty of full disclosure arising from a voluntary decision to speak rests upon its interpretation of *Chiarella.*

> The failure to disclose material information is actionable only 'when [one] is under a duty to do so. And the duty to disclose arises when one party has information that the other party is entitled to know *because of* a fiduciary or other similar relationship of trust and confidence between them.' *Chiarella v. United States,* 445 U.S. 222, 228, 100 S.Ct. 1108, 1114, 63 L.Ed.2d 348 (1980).
>
> Consequently, for Windon to premise liability on Mr. Snipes and P.M.M. for their alleged failure to disclose, Windon must provide facts which demonstrate that a relationship of trust and confidence existed between the parties . . .
>
> Although *Chiarella* involved the issue of insider liability, the Court there unequivocally rejected the proposition that all participants in market transactions are under a general duty to disclose material, nonpublic information. (Formulation of such a broad duty . . . departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . ) Windon fails to allege any relationship, and the record raises no inference of a relationship between Mr. Olson and Mr. Snipes which would provide a basis for a conclusion that Mr. Olson reasonably relied on his conversation with Mr. Snipes. To insinuate more into the Snipes-Olson

> communication would transform Rule 10b-5 into a general liability statute. The Congressional history belies this reading. See *Chiarella,* 445 U.S. at 226, 100 S.Ct. at 1113.
>
> The alleged misrepresentation or omissions of Mr. Snipes acting on behalf of P.M.M. *become* remote and tangential in light of the nonexistence of a relationship. *While we may indulge inferences in Windon's favor that Mr. Snipes' alleged interlocking business with C.R.I. influenced his communication with Mr. Olson, we cannot accept Windon's theory that once Mr. Snipes voluntarily communicated information to Mr. Olson, Mr. Snipes was under a duty to provide additional information.* The absence of this key factual allegation is fatal to establishing the legal element of justifiable reliance.
> [Citations omitted; Emphasis added]

*Windon Third Oil and Gas Drilling Partnership v. Federal Deposit Insurance Corporation,* 805 F.2d 342, 347 (10th Cir. 1986).

*Chiarella* is easily distinguishable from the instant case. Chiarella was a financial printer who had no contact of any kind with the shareholders of the corporation whose stock he purchased based on information he learned in his position with a print shop. The Court concluded that Chiarella owed no duty of disclosure:

> [The] element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

*Chiarella v. United States*, 445 U.S. at 232-33, 100 S.Ct. at 1116-17.

In this case, plaintiffs were not dealing in an impersonal market transaction. Snipes had personal contact with Olson and provided information which he was informed would later be utilized in connection with the purchase of securities. The Court in *Rose* after discussing the duty owed when there has been an affirmative act of direct communication similar to the instant case, distinguished the duty present when there has been nondisclosure in an impersonal transaction such as *Chiarella:*

> At the opposite end of the spectrum, as I would rationalize the cases, is a different sort of 'duty,' which arises in true 'nondisclosure' situations. In these instances there has been no affirmative act of communication by the defendant to the plaintiff which triggers an obligation on the defendant's part. The defendant's 'duty' here, instead, is a matter which arises solely by virtue of some pre-existing special relationship with the plaintiff; and is what in some respects might be more accurately referred to as a 'duty to come forward.' It was the sort of 'duty' with which the Supreme Court was concerned in *Chiarella.*

*Rose v. Arkansas Valley Environmental and Utility Authority*, 562 F.Supp. 1180, 1207 (W.D.Mo. 1983).

As the District Court in *Rowe v. Maremont Corp*, No. 77-C2837 (N.D. Ill. June 3, 1986) noted, *Chiarella's* language about relationship of "trust and confidence" does not suggest the sole way in which a duty to disclose arises. "*Chiarella's* language about 'trust and confidence' does not change the above rule" requiring the imposition of a duty to disclose when a defendant has chosen to selectively disclose material information. *Rowe*, slip op. in appendix, citing *Rose v. Arkansas Valley Environmental & Utility Authority*, 562 F.Supp. at 1207.

There is nothing in the language of *Chiarella* which compels the Tenth Circuit's conclusion that an additional duty of complete and truthful disclosure cannot be imposed when a defendant has chosen to speak.

> Although Justice Powell used the insider/shareholder and buyer/seller relationships as examples of contexts in which an affirmative duty might arise, it is clear from the rest of the opinion that those are not the only circumstances in which an affirmative duty exists.

*Issen v. GSC Enterprises, Inc.*, 538 F.Supp. at 751 n.9.

Consequently, the restrictive interpretation of *Chiarella* adopted by the Tenth Circuit Court of Appeals should be reviewed on certiorari as it represents an erroneous interpretation of an opinion of this Court in conflict with other Circuit Courts' decisions.

## V. CONCLUSION

For the reasons set forth herein, petitioners respectfully submit that the Tenth Circuit Court of Appeals' affirmance of the opinion of the Western District of Oklahoma's grant of summary judgment in favor of defendants PMM and Snipes should be reviewed on certiorari. The Tenth Circuit Court of Appeals has rendered a decision which is in direct conflict with the decisions of other Circuit Courts of Appeals on the same matter.

Respectfully submitted,

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## APPENDIX


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WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*,
*Plaintiffs-Appellants,*

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,
*Defendants,*

PEAT, MARWICK, MITCHELL & CO. AND A. MARSHALL SNIPES,
*Defendants-Appellees.*

**No. 85-2211.**

UNITED STATES COURT OF APPEALS,
Tenth Circuit.

Nov. 10, 1986.

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Steven M. Steingard (Mitchell A. Kramer, with him on the briefs), Philadelphia, Pa., for plaintiffs-appellants.

William E. Hegarty of Cahill Gordon & Reindel, New York City (J. William Conger of Hartzog Conger & Cason, Oklahoma City, Okl., Earl D. Mills of Mills Whitten Mills & Mills, Oklahoma City, Okl., and Victor M. Earle, III, and Edwin D. Scott, of Peat, Marwick, Mitchell & Co., of counsel, New York City, with him on the brief), for defendants-appellees.

Before McKAY and MOORE, Circuit Judges, and BROWN, District Judge.*

JOHN P. MOORE, Circuit Judge.

In this appeal from a judgment entered pursuant to Fed.R.Civ.P. 54(b), we are asked to consider whether the district court properly granted the motion for summary judgment, foreclosing plaintiffs' federal securities and pendent state fraud claims from trial on the merits. In light of the Supreme

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* Honorable Wesley E. Brown, Senior United States District Judge for the District of Kansas, sitting by designation.

Court's recent decisions in *Celotex Corporation v. Catrett*, ____ U.S. ____, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986), and *Anderson v. Liberty Lobby, Inc.*, ____ U.S. ____, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986), we have reviewed the records, exhibits, and briefs and conclude no factual dispute cognizable within federal securities law is present to permit plaintiffs' proceeding to trial on this issue. We therefore affirm the order of the district court.

## I.

This litigation surfaced in the aftermath of the insolvency of Penn Square Bank (Penn Square) in Oklahoma City, Oklahoma. Windon Third Oil and Gas Drilling Partnership, Windon Fourth Oil and Gas Drilling Partnership and Windon Fifth Oil and Gas Drilling Partnership (Windon collectively or plaintiffs/appellants) are Pennsylvania limited partnerships which were formed to acquire fractional interests in oil and gas leases for wells in Oklahoma, Kansas, and Texas. Windon retained Clifford Resources, Inc. (C.R.I.), whose president, Hal Clifford, had previously supervised the exploration, development, and operation of Windon partnership wells.[1] Pursuant to the terms of the partnership plans, the partnership entities executed agreements with Penn Square in which individual limited partners borrowed the capital to purchase an interest in a unit of the limited partnership. Each loan agreement apparently contained an interest reserve clause earmarking 20% of the principal of each note for payment of interest due. When Penn Square was declared insolvent, the Federal Deposit Insurance Corporation (FDIC) and Deposit Insurance National Bank (DINB),[2] appointed receivers of the failed bank, took over the notes and declared them in default for nonpayment of interest allegedly in disregard of the terms of the original loan agreements.

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[1] According to the Confidential Memorandum offering Windon, the general partners of Windon, Robert P. Olson and James A. Weiss, were also general partners of Windon First and Windon Second Oil and Gas Drilling Partnerships, whose oil and gas interests were also operated by C.R.I. [R. II, at 353].

[2] The DINB is a new bank created to assume and distribute Penn Square's insured deposits.

Consequently, Windon[3] and approximately sixty-five individual limited partners[4] filed a complaint alleging breach of contract, common law fraud, and violations of federal securities laws in the United States District Court for the Western District of Oklahoma against the FDIC; DINB; three officers of Penn Square, Bill Patterson, Bill P. Jennings, and Eldon L. Beller; Peat, Marwick, Mitchell & Co. (P.M.M. or appellee), an accounting firm that audited the books and records of Penn Square and C.R.I.; and A. Marshall Snipes (appellee), an accountant employed by P.M.M. This appeal concerns only the dismissal of Windon's Counts V and VI for common law fraud and federal securities violations respectively upon summary judgment entered in favor of Mr. Snipes and P.M.M.

In an amended complaint,[5] Windon alleged a violation of 15 U.S.C. § 78j(b) and Rule 10b-5, stating that on October 8, 1979, Robert P. Olson, Windon's representative and general partner, telephoned Mr. Snipes, then a manager of P.M.M., allegedly seeking due diligence information in anticipation of the formation of the Windon partnerships. Responding to Mr. Olson's questions, Mr. Snipes allegedly represented that he and ten other P.M.M. partners invested exclusively with C.R.I.; C.R.I.'s oil reserves were worth several million dollars; C.R.I.'s cash flow was approximately $45,000 a month from its reserves; and P.M.M. partners had invested some $250,000 with C.R.I. personally. Windon alleged Mr. Snipes knew that Mr. Olson

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[3] Originally, Windon 81A Oil and Gas Drilling Partnership joined in the complaint. On June 2, 1981, Windon 81A dismissed all of its claims, leaving the three limited partnerships and most of their individual limited partners in the action.

[4] For clarity, the individual limited partners are included in the collective "Windon" designation.

[5] In its order of March 1, 1984, in response to appellees' first motion for summary judgment, the court dismissed Count VI for failure to state a claim under the federal securities laws and Count V, common law fraud, for lack of complete diversity between Windon, P.M.M., and Mr. Snipes. The court then gave Windon 10 days to amend the complaint. In the amended complaint, Windon realleged the violations of federal securities laws in conformity with the court's order. Windon again invoked the court's pendent jurisdiction by reincorporating Count V for common law fraud into the amended complaint.

was conducting due diligence in the formation of the limited partnerships and that Mr. Olson would rely on his statements. Windon alleged Mr. Snipes failed to disclose that he and several P.M.M. partners had personally obtained loans from Penn Square with the assistance of C.R.I.; that P.M.M. gained additional fees for rendering accounting services to Penn Square; and that P.M.M. partners did not invest exclusively with C.R.I. Windon averred that it discovered the alleged securities violations when Penn Square was declared insolvent. As a consequence of appellee's alleged misrepresentations and nondisclosures, Windon complained it paid more for the investment and sought for its remedy the difference between the cost paid and the actual value of the investment when made or, alternatively, the cost of the investment.

Mr. Snipes and P.M.M. again moved for summary judgment, contending plaintiffs had failed to allege facts to satisfy the elements of a Rule 10b-5 claim; and, absent federal jurisdiction, they further sought dismissal of the state claim for lack of subject matter jurisdiction. Appellees resubmitted Mr. Snipes' original affidavit which averred he received a personal call from a man whose name he did not remember and generally denied he had made each of the representations Windon attributed to him. Windon resisted the motion, countering with Mr. Olson's second affidavit, exhibits, a newspaper clipping, and responses to interrogatories.

In granting summary judgment in favor of P.M.M. and Mr. Snipes, the court characterized Mr. Snipes' statements and opinions as "at most tangential" to Windon's investment decision and ultimately too remote from the subject oil and gas investments to be material within the meaning of Rule 10b-5 as set forth in *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983). Nor, in the court's assessment, did Windon demonstrate justifiable reliance in light of the remoteness of the statements and the disclaimers and caveats in the Windon Third investment memorandum. The court found no fiduciary relationship existed between Messrs. Snipes and Olson to permit an inference of reliance or, alternatively, to support a

separate element of a 10b-5 claim. The underlying claim thus negated, the court rejected as insufficient Windon's factual allegations of Mr. Snipes' and P.M.M.'s knowing participation with Penn Square to support Windon's claim for aiding and abetting liability. With no independent basis for federal jurisdiction, the court then dismissed Windon's state law claim.

## II.

In this appeal, Windon urges the district court erred in mischaracterizing this case, focusing only on the misrepresentation rather than on the nondisclosures. Windon contends the court's inability to find material misrepresentations in the offering memorandum underscores the essential nondisclosure of C.R.I.'s financial condition of which it now complains. Windon insists Mr. Snipes' alleged nondisclosures and misrepresentations are material in painting a picture of a financially stable C.R.I. This misrepresentation, Windon alleges, led to the selection of C.R.I. as operator, which, in practical terms, becomes the key to a successful drilling program. In support of its position, Windon cites *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), which held that in "failure to disclose" cases, positive proof of reliance is not a prerequisitie to recovery. *Id.* at 153. Appellant asks us to apply the proper standard for summary judgment in securities cases, particulary in the light of the wholly contradictory affidavits and evidence of business interlocks between Penn Square, C.R.I., Mr. Snipes, and P.M.M.

In response, appellees contend summary judgment appropriately disposed of Windon's claim of "omissions of immaterial facts . . . on an attenuated causal theory against peripheral actors who were not even bystanders to a securities transaction." Although facts may have been disputed, appellees contend no legal significance attaches to those facts under Rule 10b-5.

While the debate over summary judgment continues,[6] the Supreme Court has recently addressed the issues of the movant's burden in summary judgment in *Celotex Corp. v. Catrett*, ____U.S.____, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986), and the applicable standard of proof in *Anderson v. Liberty Lobby, Inc.*, ____U.S.____, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Our review is guided by these discussions. In *Celotex*, the Court clarified that interpretation of Rule 56(c) in *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 90 S.Ct. 1598, 26 L.Ed.2d 142 (1970), which placed the burden on "the moving party . . . to show intially the absence of a genuine issue concerning any material fact." *Id.* at 159, 90 S.Ct. at 1609. The Third Circuit had construed this language to require the moving party to "support its motion with affidavits or other similar materials *negating* the opponent's claim." *Celotex*, 106 S.Ct. at 2533. Reversing the court of appeals, the Court concluded, "We do not think the *Adickes* language . . . should be construed to mean that the burden is on the party moving for summary judgment to produce evidence of the absence of a genuine issue of material fact, even with regard to an issue on which the nonmoving party bears the burden of proof." *Id.* at 2554. Instead, the movant's burden under Rule 56 is circumscribed by an initial showing of the absence of evidence to support the nonmoving party's case. *Id.* The movant must identify those portions of "the pleadings, depositions, answers to interrogatories and admissions on file, together with affidavits if

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[6] Even in the Court's recent decisions, unanimity was absent. In *Anderson v. Liberty Lobby, Inc.*, _____ U.S. _____, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986), Justices Brennan and Rehnquist and the Chief Justice dissented from the majority opinion. Justices Brennan, Stevens, Blackmun and the Chief Justice dissented in *Celotex Corp. v. Catrett*, _____ U.S. _____, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986).

any." to demonstrate the absence of a genuine issue of material fact. Fed.R.Civ.P. 56(c) [7] *Celotex* requires no more. The moving party's burden cannot be enhanced to require his proof of a negative; that is, not only is there no evidence in the record, but plaintiff's evidence need not be disproved.

*Anderson v. Liberty Lobby, Inc.*, 106 S.Ct. at 2505, addressed the issue of the quantum of evidence necessary to withstand summary judgment in an action for libel. To make this determination, a trial court must look to the substantive law in order to identify which facts are relevant "since materiality is only a criterion for evaluating the evidentiary underpinnings of those disputes." *Id.* at 2510. Since the evidence of the nonmoving party is deemed true and all reasonable inferences are drawn in his favor, the nonmoving party "need only present evidence from which a jury might return a verdict in his favor." *Id.* at 2514. Further, determinations of credibility, weighing the evidence, and the drawing of legitimate inferences from the facts remain in the preserve of the jury. Thus, when the finder of fact decides a motion for summary judgment based on the lack of proof of a material fact, the judge must ask, reasoned the *Anderson* court, whether a "fair-minded jury" could return a verdict for the plaintiff on the evidence presented.

We, thus, premise our review of the district court's granting summary judgment on this rubric. Windon's factual allegations must be scrutinized to determine whether inferences deriving from and cognizable within securities law are permissible.

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[7] The Court looked to the language of Rule 56(c) referring to affidavits *"if any"* and sections (a) and (b) of Rule 56 indicating that claimants and defendants may move for summary judgment *"with or without supporting affidavits"* to support its discussion of the movant's burden. However, conclusory assertions to aver the absence of evidence remain insufficient to meet this burden. Otherwise, as Justice Brennan cautioned, summary judgment "[would] be converted into a tool for harassment." *Celotex*, 106 S.Ct. at 2554 (Brennan, J. dissenting).

## III.

Section 10(b) of the 1934 Exchange Act, 15 U.S.C. § 78j(b), prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." The SEC promulgated Rule 10b-5 which provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> . . . .
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .

17 C.F.R. § 240.10b-5(b) (1986). These provisions must be read flexibly, not technically and restrictively. *Superintendent of Insurance of State of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12, 92 S.Ct. 165, 168, 30 L.Ed.2d 128 (1971).

When we apply the facts as alleged to the Rule, we recognize appellees initially have the burden to establish there is no genuine issue concerning a material fact to permit summary judgment as a matter of law. A genuine issue "must be predicated on a viable legal theory." *Spectrum Financial Companies v. Marconsult, Inc.*, 608 F.2d 377, 380 (9th Cir. 1979), *cert. denied*, 446 U.S. 936, 100 S.Ct. 2153, 64 L.Ed.2d 788 (1980) (citation omitted). Mr. Snipes and P.M.M. must show, taking all of Windon's allegations as true and resolving all inferences in Windon's favor, that Windon has failed to provide any evidence to establish an essential element of Rule 10b-5. Appellees need not *disprove* Windon's claim but only establish that the factual allegations have no legal significance and, thus, fail to satisfy the statutory requisites.

Windon alleged that Mr. Snipes and P.M.M. failed to disclose material information and misrepresented information about C.R.I.'s financial stability before the creation of the limited partnerships that would have affected the amount a limited partner paid for his investment. For example, Windon alleged that Mr. Snipes had completed an audit of C.R.I. prior to his conversation with Mr. Olson. The audit found in C.R.I.'s file revealed a cash flow deficit in contrast to Mr. Snipes' alleged statement about a positive cash flow. Since we take these allegations as true, we next must determine how they establish an element of the substantive terrain of Rule 10b-5. In other words, to have legal significance, the allegation must be material, made in connection with the purchase or sale of a security, and be one on which Windon reasonably relied.

The failure to disclose material information is actionable only "when [one] is under a duty to do so. And the duty to disclose arises when one party has information that the other party is entitled to know *because of* a fiduciary or other similar relation of trust and confidence between them." *Chiarella v. United States,* 445 U.S. 222, 228, 100 S.Ct. 1108, 1114, 63 L.Ed.2d 348(1980) (citation omitted). A duty arises from the relationship between the parties not merely because one party has an ability to acquire information. *Id.* at 231, n. 14, 100 S.Ct. at 1116, n. 14. Without a duty to disclose, silence cannot be made fraudulent.

Consequently, for Windon to premise liability on Mr. Snipes and P.M.M. for their alleged failure to disclose, Windon must provide facts which demonstrate that a relationship of trust and confidence existed between the parties. That relationship may be preexisting (allegations of prior dealings) or arise upon the facts and circumstances of the information communicated (allegations that an agency or other fiduciary relationship was created). These allegations would permit an inference that Mr. Snipes had a duty to disclose fully to Mr. Olson. Absent these assertions, the substantive body of securities law must limit the range of permissible inferences we may entertain to decide Windon has met its initial burden of persuasion.

Although *Chiarella* involved the issue of insider liability, the Court there unequivocally rejected the proposition that all participants in market transactions are under a general duty to disclose material, nonpublic information. "Formulation of such a broad duty . . . departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . ." Windon fails to allege any relationship, and the record raises no inference of a relationship between Mr. Olson and Mr. Snipes which would provide a basis for a conclusion that Mr. Olson reasonably relied on his conversation with Mr. Snipes. To insinuate more into the Snipes-Olson communication would transform Rule 10b-5 into a general liability statute. The Congressional history belies this reading. *See Chiarella,* 445 U.S. at 226, 100 S.Ct. at 1113.

The alleged misrepresentations or omissions of Mr. Snipes acting on behalf of P.M.M. *become* remote and tangential in light of the nonexistence of a relationship. While we may indulge inferences in Windon's favor that Mr. Snipes' alleged interlocking business with C.R.I. influenced his communication with Mr. Olson,[8] we cannot accept Windon's theory that once Mr. Snipes voluntarily communicated information to Mr. Olson, Mr. Snipes was under a duty to provide additional information. The absence of this key factual allegation is fatal to establishing the legal element of justifiable reliance.

Rule 56 must be applied not only to assure a party asserting claims and defenses adequately based in fact that those claims and defenses will be tried to a jury, but also to assure those opposing such claims and defenses that they will be spared undue litigation when no triable issue exists. *Celotex,* 106 S.Ct. at 2555. We therefore affirm the order of the district court and remand the action for adjudication of Windon's remaining claims not disposed of by the district court's order of May 19, 1986.

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[8] Windon does state almost in passing that C.R.I. referred Mr. Olson to Mr. Snipes. Absent other facts in the record, the law cannot engraft the alleged relationship between Mr. Snipes and C.R.I. onto the brief telephone encounter between Mr. Snipes and Mr. Olson.

IN THE

# UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF OKLAHOMA

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**CIV-83-536-E**

---

WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*,
*Plaintiffs,*

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,
*Defendants.*

## ORDER

## BACKGROUND

This matter comes before the Court on the motions of defendants Marshall Snipes, individually, and Peat, Marwick, Mitchell & Co., for dismissal or summary judgment on Counts V and VI of plaintiffs' Amended Complaint. By Order dated March 1, 1984, this Court dismissed Count V (alleging common law fraud) for lack of complete diversity and Count VI (alleging securities fraud under Section 10(b) and Rule 10(b)(5) of the 1934 Securities Act, 15 U.S.C.A. § 78(j)) for failure to state a claim. The Order granted plaintiffs leave to amend their Complaint, which they have done as to Count VI.

The upshot of the amended pleading is that if Count VI adequately states a federal securities law claim, then pendent jurisdiction of Count V will lie; otherwise, if there is no federally cognizable claim under Count VI, then the Court cannot entertain pendent jurisdiction of plaintiffs' claims in Count V under either the Securities Exchange Act of 1934, 15 U.S.C.A. § 78(a), or under the diversity statute, 28 U.S.C.A. § 1332.

The thrust of amended Count VI is that on or about October 8, 1979, Snipes was contacted by a Mr. Robert Olson, on behalf of the Windon Partnerships, seeking information about Clifford Resources, Inc. (CRI). Windon was considering the purchase of oil and gas leases from CRI, and ultimately several Windon Partnerships did purchase CRI oil and gas leases. It is alleged that the partnerships and their limited partners "paid more for their partnership interest than the (true) value of the CRI properties . . ." and that during the October 8 telephone conversation, Snipes made the following statements: that he and other Peat, Marwick ("PMM") partners invested exclusively with "Clifford";[1] that PMM partners had personally invested $250,000 with CRI; that CRI's oil reserves were worth several million dollars, and that CRI's cash flow was approximately $45,000 monthly. The Complaint alleges that Snipes failed to disclose that he had three personal loans from Penn Square Bank totaling $600,000; that other Peat, Marwick partners had obtained loans from Penn Square "with the aid and influence of CRI"; that CRI arranged the loans to Peat, Marwick, partners, "so that Penn Square would continue to make loans to CRI and those doing business with CRI"; that Peat, Marwick stood to gain professional accounting service fees from Penn Square, and that Peat, Marwick partners in fact did not invest exclusively in CRI. It is further alleged that "Snipes, acting on behalf of PMM, knew or should have known that the information concerning said loan transactions was of critical importance to the (Windon) partnerships, because of PMM's and Snipes' congruity of interest and given the importance of CRI's financial stability and reputation in the plaintiffs' decision to enter into agreements with CRI for their wells." (Plaintiff's Amended Complaint, March 20, 1984, para. 73-74 at 6.)

In response, Peat, Marwick and Snipes argue that even taking plaintiffs' allegations as true,

> "There is simply no logical or legal connection whatsoever between what Snipes said or failed to say

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[1] The "Clifford" of CRI is an individual, Mr. Hal Clifford. It is unclear from the pleadings whether Snipes was referring to investments with Clifford personally or with CRI.

and any purchase of the security by any plaintiff. Snipes is not alleged to have commented at all about the soundness or value of an investment in either Windon Limited Partnership Units or any specific oil and gas properties. Stripped to its essentials, Snipes failed to tell plaintiffs of an alleged relationship between (Peat, Marwick) and Penn Square Bank. But there is no connection between this conversation and plaintiffs' security transactions." (Reply Memorandum of defendants Peat, Marwick, Mitchell & Co. and Marshall Snipes, December 12, 1984, at 4.)

Defendants point to the investment memorandum for the Windon Partnerships, which expressly disclaimed any representation with respect to any specific oil and gas property and advised investors that the Windon general partners had not determined at the time of the offering either the quantity or the location of the properties to be acquired. (The Windon Memorandum did, however, identify CRI as the driller and operator of the investment wells.) (Reply in Further Support of Defendants Peat, Marwick & Snipes, Dec. 12, 1984, App. A at A-2, A-3.) Defendants emphasize that "Snipes is not alleged to have commented on the value of, or recommended the purchase of, any of the oil and gas properties allegedly purchased by the Windon partnerships. The alleged comments pertained only to CRI itself. Thus, the partnership plaintiffs . . . failed to allege a misrepresentation relating to a purchase of securities . . . ." (Defendants' Reply Memorandum, December 12, 1984, at 7.)

## DISCUSSION

Pursuant to 310 of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j), the Securities Exchange Commission promulgated what has become widely known as Rule 10(b)(5), 17 C.F.R. § 240.10(b)(5), which provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

A general proposition recognized by the Tenth Circuit is that "in a misrepresentation case under Rule 10(b)(5), a plaintiff must establish in connection with the purchase or sale of the security (that) the defendant, with scienter, made a false representation of a material fact upon which the plaintiff justifiably relied to his or her detriment. (Citation)" *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983).

The supplementary affidavits and exhibits submitted by the parties convert defendants' motion to dismiss into a motion for summary judgment. 5 C. Wright & A. Miller, *Federal Practice & Procedure: Civil*, § 1366 (1969); *Torres v. First State Bank of Sierra County*, 550 F.2d 1255, 1257 (10th Cir. 1977). Snipes and Peat, Marwick can prevail only if plaintiff's allegations, taken as true, fail to establish the elements of materiality and justifiable reliance essential to a 10(b)(5) claim, thereby entitling Snipes and Peat to judgment as a matter of law. The Court will consider in turn each of these essential 10(b)(5) elements.

**Materiality**

Material facts, in the context of Rule 10(b)(5), are those which a reasonable investor might have considered important in making an investment decision. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-154 (1972). The basic test of materiality is whether a reasonable man would attach impor-

tance to the misrepresented fact in determining his course of action. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2nd Cir. 1965), *cert. denied* sub nom. *List v. Lerner*, 382 U.S. 811 (1965). The materiality test is to be evaluated from the standpoint of a prototype reasonable investor, and the surrounding circumstances must be examined to determine whether there is a substantial likelihood that a reasonable investor would attach importance to the alleged misrepresentation or omission. *In Re Home-Stake Production Company Securities Litigation*, 76 F.R.D. 351 (N.D. Okla. 1977). "Misrepresented or omitted facts become material, hence actionable under 10(b)(5), when, considering the complaining parties as reasonable investors, the disclosure of the undisclosed facts or candid revelation of misleading facts would affect their trading judgment." *Mitchell v. Texas Gulf Sulphur Company*, 446 F.2d 90, 97 (10th Cir. 1971).[2]

Snipes' accuracy and candor in describing to Olsen the loans and financial relations between Snipes, Clifford, Peat Marwick, and Penn Square, are at most tangential to Windon's investment decision concerning certain particular CRI oil and gas leases. *Hickman v. Groesbeck*, 389 F.Supp. 769, 776 n. 13 (D. Utah 1974). Nor can it reasonably be said that either Snipes' representations concerning CRI's general assets and revenues or the true extent of Snipes' personal financial investments in third-party ventures interlocking with CRI would have altered or affected the investment decision of Windon Third or its partners regarding CRI-owned mineral leases. The substance of Snipes' purported remarks are simply too remote from the subject oil and gas investments to be considered material within the meaning of Rule 10(b)(5).

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[2] The "objectively reasonable" test which has been applied to claims brought under Section 10(b)(5) [*Zobrist; Heit v. Weitzen*, 402 F.2d 909, 912-914 (2nd Cir. 1968)], *cert. denied* 395 U.S. 903 (1968), has also been applied to claims brought under Section 12(2) of the 1934 Act [*Gilbert v. Nixon*, 429 F.2d 348, 356, 10th Cir. 1970], and Rule 14(a)(9) of the 1934 Act, concerning proxy statements [*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-449 (1976)].

**Reliance**

The reliance requirement is an outgrowth of the causation requirement which is a prerequisite to recovery under Rule 10(b)(5). *Feldman v. Pioneer Petroleum, Inc.*, No. 77-0012, slip op. at 2-7 (W.D. Okla. April 13, 1983); CCH Fed.Sec.L.Rep. § 99, 173 (May 4, 1983). Reliance is not considered to follow automatically from a showing of abstract wrong, and the plaintiff is obliged to prove both his reliance and its justification. *Holdsworth v. Strong*, 545 F.2d 687, 695-696 (10th Cir. 1976). As recently stated by our Circuit, "Justifiable reliance is not a theory of contributory negligence; rather, it is a limitation on a Rule 10(b)(5) action which insures that there is a causal connection between the misrepresentation and the plaintiff's harm." *Zobrist*, 708 F.2d at 1516.

The following factors are relevant in determining justifiable reliance:

> (1) The sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long-standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations. (citations) No single factor is determinative; all relevant factors must be considered and balanced to determine whether reliance was justified. (citations)"

*Zobrist*, 708 F.2d at 1516, 1517.

In *Zobrist* the Tenth Circuit found that investors could not be said to have justifiably relied upon oral misrepresentations regarding coal properties and mining operations, in light of express disclaimers and risk notices in the coal venture's private placement memorandum and other pertinent factors.

The disclaimers and caveats in the Windon Third investment memorandum belie plaintiff's claims that any of its

partners or the partnership itself could have relied on Snipes' statements. The test of reliance is whether the misrepresentation is a substantial factor in determining the course of conduct which results in the investor's loss (*List,* 340 F.2d at 462) or, phrased differently, "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." (*List,* 340 F.2d at 463). In light of the limited information concerning Clifford & CRI contained in the Windon Third investment memorandum (Defendants' Reply Memorandum, App. A at A-(6-8) (Dec. 12, 1984), and in view of the fact that Snipes' alleged statements are manifestly unrelated to the CRI oil and gas properties, plaintiff has demonstrated no causal link or justifiable reliance relating Snipes' statement to Windon's ultimate investment decisions.

## DUTY AND FIDUCIARY RELATIONS

The existence of a fiuciary relationship is pertinent both to the issue of reliance, *supra,* and as an independent element of defendant's 10(b)(5) liability for omission of a necessary disclosure. *Financial Industrial Fund, Inc. v. McDonnell-Douglas Corp.,* 474 F.2d 514, 521 (10th Cir. 1973). It has been stated by the Eighth Circuit that:

> "no one who fails to disclose material information prior to the confirmation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other (party) is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' *Chiarella v. United States,* 445 U.S. 222, 228 (1979). Liability under Rule 10(b)(5) for nondisclosure is premised on a duty to disclose arising from a relationship of trust and confidence between the parties."

*Laventhall v. General Dynamics Corp.,* 704 F.2d 407, 412 (8th Cir. 1983), *cert. denied* U.S. , 104 SCt 150 ( );

*accord D & G Enterprises v. Continental Illinois National Bank,* 574 F.Supp. 263 (N.D. Ill. 1983). There is nothing to indicate that Snipes had a fiduciary relation with Olson, the Windon partnership, or individual Windon partners. From all indications, Snipes was fortuitously solicited by Olson concerning the former's opinion as to CRI. Section 10(b) of the 1934 Act is not a general bystander liability statute [*ITT v. Cornfeld,* 619 F.2d 909, 927 (2nd Cir. 1980)] and in this Court's opinion, present law does not impose a fiduciary duty on an individual who is not an insider and who neither volunteered his views nor enjoyed direct involvement in the subject transaction.

## AIDING AND ABETTING

Plaintiffs claim that Snipes and Peat Marwick aided and abetted the securities fraud allegedly committed by the remaining defendants. However, plaintiffs' allegations and the facts as pleaded fail to demonstrate "knowing participation" by Snipes and Peat Marwick in the fraudulent scheme of the other defendants. *Zabriskie v. Lewis,* 507 F.2d 546 (10th Cir. 1974). Our circuit holds that "knowledge of the illegality of the scheme is . . . essential to aiding and abetting. In addition, the party charged with aiding and abetting must have rendered substantial assistance." *Mawod & Co. v. SEC,* 591 F.2d 588 (10th Cir. 1979); *accord, Cleary v. Perfectune, Inc.,* 700 F.2d 774 (1st Cir. 1983); *Decker v. Massey-Ferguson, Ltd.,* 681 F.2d 111 (2nd Cir. 1982); *Walck v. American Stock Exchange, Inc.,* 565 F. Supp. 1051 (E.D. Pa. 1981), aff'd 687 F.2d 778 (3rd Cir. 1982), *cert. denied* 461 U.S. 942 (1983), *reh. denied* U.S. , 104 SCt 29 (1983). Under the most generous view of the amended complaint and supporting documents, the Court finds no conceivable basis for aiding and abetting liability, either as to Peat Marwick (as alleged in para. 80 of the original Complaint) or as to Snipes and Peat Marwick jointly (as alleged in para. 80 of the Amended Complaint).

## CONCLUSION

Viewing the facts and allegations in the light most favorable to plaintiff, it is clear as a matter of law that plaintiff cannot prevail in its allegations against defendants Snipes and Peat Marwick in Count VI. Accordingly, summary judgment in favor of those defendants on Count VI is hereby entered.

There being no independent basis for federal jurisdiction concerning plaintiff's common law fraud claims in Count V as to the named defendants, the allegations in Count V as to Snipes and Peat Marwick are dismissed. *United Mine Workers of America v. Gibbs*, 383 U.S. 715 (1966); *Central National Bank v. Rainbolt*, 720 F.2d 1183, 1187 (10th Cir. 1983); *Walling v. Beverly Enterprises*, 476 F.2d 393, 398 (9th Cir. 1973).

DATED this 25 day of April, 1985.

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LUTHER B. EUBANKS
UNITED STATES
DISTRICT JUDGE

Entered in Judgment Docket
on 4-25-85

IN THE

# UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF OKLAHOMA

**Case No. CIV 83-536E**

WINDON THIRD OIL & GAS DRILLING PARTNERS, *et al.*,
*Plaintiff,*

vs.

PENN SQUARE BANK, N.A., *et al.*,
*Defendants.*

## ORDER

Whereas plaintiffs have moved this Court for certification of its April 25, 1985 Order as a final Order pursuant to F.R.Civ.P. 54(b), and

Whereas defendants Peat, Marwick, Mitchell & Co. ("PMM") and A. Marshall Snipes ("Snipes") have indicated by stipulation that they do not oppose said motion,

IT IS HEREBY ORDERED that this Court's Order granting summary judgment in favor of defendants PMM and Snipes, is certified this 20 day of June, 1985 as a final judgment as to those defendants pursuant to F.R.Civ.P. 54(b) as this Court finds that there is no just reason for delay.

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J.

IN THE

# UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF OKLAHOMA

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**CIV-83-536-E**

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WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*,
*Plaintiffs,*

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,
*Defendants.*

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## ORDER

Before the Court is the FDIC's Motion for Judgment on the Pleadings as to Counts IV, VI & VII, or in the Alternative, Motion for Summary Judgment. The Court will treat the motion as one for judgment on the pleadings. Accordingly, the Court will construe all well-pleaded factual allegations of the plaintiffs as true and will draw from those facts all reasonable inferences in favor of the plaintiffs. *Iowa Beef Processors, Inc. v. Amalgamated Meat Cutters & Butcher Workmen of North America,* 627 F.2d 853 (8th Cir. 1980).

In Count IV plaintiffs present a common-law fraud claim against the FDIC. First, plaintiffs allege Penn Square Bank (PSB) failed to disclose to plaintiffs an agreement between PSB and Clifford Resources International (CRI); the agreement was that CRI would purchase problem loans from PSB and PSB would finance such purchases. Second, plaintiffs allege PSB falsely represented that the risk to the Bank and to investors was very small because "there was 'no way that he (Clifford) is not going to make 2 for 1.'" Third, plaintiffs allege PSB represented that the loans made by PSB would be amply collateralized.

The FDIC contends the alleged omission and misrepresentations do not amount to actionable fraud because silence as to a material fact is not equivalent to false representation and the alleged misrepresentations referred to future events and were merely opinions.

The Court finds that the allegations against Penn Square in Count IV, taken as a whole, state a claim for common-law fraud. Plaintiffs allege Penn Square personnel made misrepresentations to them in order to encourage them to buy partnership interests and oil and gas interests and thereby create further business for the Bank. Plaintiffs also allege Penn Square omitted from those (mis)representations the relationship and business dealings between the Bank and Clifford Resources, which was the seller of the oil and gas interests and operator of the wells. In its reply brief, the FDIC includes this quotation:

> In the absence of an intention to deceive, and of conduct in furtherance of that intent, *fraud cannot be predicated upon a mere expression of opinion, even though the speaker does not disclose all the facts known to him on which his opinion is based.*

37 Am. Jur. 2d *Fraud and Deceit* § 151 (emphasis added). (FDIC Reply Memorandum at p. 4.) The FDIC then proceeds to ignore the introductory clause of that quotation. Plaintiffs have alleged Penn Square's intention to deceive. Because the Court must read the Amended Complaint in the light most favorable to plaintiffs, it cannot grant FDIC's Motion for Judgment on the Pleadings on Count IV.

In Count VI of the Amended Complaint, plaintiffs assert that the same conduct pled in Count IV (for common-law fraud) constitutes a violation of § 10b of the Securities Exchange Act of 1934 as amended, 15 U.S.C. § 78j(b) and the rules and regulations thereunder. Plaintiffs apply their § 10(b) argument to the limited partners' purchases of partnership interests and the partnership's purchases of oil and gas leases from CRI.

As a starting point, the Court recognizes this basic premise described by the Tenth Circuit: "In a misrepresentation case

under rule 10b-5, a plaintiff generally must establish that in connection with the purchase or sale of a security, the defendant, with scienter, made a false representation of a material fact upon which the plaintiff justifiably relied to his or her detriment." *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983). Accordingly, the Court will consider the materiality and reliance aspects of plaintiffs' allegations.

Materiality in a 10b-5 claim is determined by considering whether a reasonable investor's decision would be affected by "the disclosure of the undisclosed facts or candid revelation of misleading facts." *Mitchell v. Texas Gulf Sulphur Company*, 446 F.2d 90, 97 (10th Cir. 1971). Such a determination of what would affect a reasonable person's investment decision should in this case be made by the trier of fact. When construing the Amended Complaint's Count VI allegations favorably to plaintiffs, the Court concludes plaintiffs have alleged materiality sufficiently to preclude granting the FDIC's motion for judgment on the pleadings.

Turning to the issue of reliance, the Court must consider the *Zobrist* case, *supra*, and the Court's April 25, 1985, Order in the case at bar. *Zobrist* contains a list of factors used to determine whether reliance was justifiable. They are: (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations. *Zobrist*, 708 F.2d 1511, 1516 (10th Cir. 1983). In *Zobrist*, knowledge of the disclaimers and risk notices in the private placement memorandum was imputed to the investor. After consideration of the above-listed factors, coupled with the investor's imputed knowledge of the warnings in the private placement memorandum, the court concluded plaintiffs' reliance on oral misrepresentations was not justified.

This Court granted summary judgment to Marshall Snipes and Peat, Marwick on Count VI as it related to Snipes' representations about the loans and financial relations between

Clifford, Penn Square, Snipes and other Peat partners. This Court concluded, "the disclaimers and caveats in the Windon Third investment memorandum belie plaintiff's claims that any of its partners or the partnership itself could have relied on Snipes' statements." *Windon Third Oil & Gas Drilling Partnership, et al. v. FDIC, et al.*, CIV-83-536-E, April 25, 1985, Order at p. 8. In accordance with that Order which is now pending on appeal and *Zobrist*, the Court finds that investors in the Windon partnerships could not have reasonably relied on the representations of Penn Square personnel.

However, the same conclusion does not apply to the purchases of oil and gas interests by the partnerships from CRI because nothing similar to the investment memorandum is alleged to have been used in connection with the purchase of those interests.

In summary as to Count VI, the 10b-5 claim, the Court funds that the materiality issue on the purchase of both the partnership interests and the oil and gas interests should be decided by the trier of fact. On the reliance issue the Court differentiates between the claim based on the purchase of partnership interests and the claim based on the purchase of the oil and gas interests. Consequently, the Court grants the Motion for Judgment on the Pleadings on Count VI as to the purchase of the partnership interests and denies the motion on Count VI as to the purchase of the oil and gas interests.

In Count VII plaintiffs assert a negligence claim against the FDIC for failing to disclose PSB's deteriorating condition to plaintiffs prior to the closing of the Bank. In accordance with *Federal Deposit Insurance Corp. v. Jennings, et al.*, 615 F. Supp. 465 (W.D. Okla. 1985), this Court finds the FDIC owed plaintiffs no duty to disclose the financial condition of PSB prior to its closing. Therefore, FDIC's Motion for Judgment on the Pleadings is granted on Count VII.

In summary, FDIC's Motion for Judgment on the Pleadings is DENIED on Count IV, GRANTED in part and DENIED in part on Count VI, and GRANTED on Count VII.

The Clerk of Court is directed to mail a copy hereof to counsel of record.

DATED this 19th day of May, 1986.

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LUTHER B. EUBANKS
United States District Judge

Entered in Judgment Docket
on 5-19-86

IN THE

# UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF OKLAHOMA

**No. CIV-83-536-E**

WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, *et al.*,
*Plaintiffs,*

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,
*Defendants.*

## ORDER

Before the Court are a number of motions, largely challenging the sufficiency of the plaintiffs' complaint pursuant to Federal Rules of Civil Procedure 9(b) and 12(b)(6). First, the defendant Deposit Insurance National Bank ["DINB"] has moved to dismiss for failure to state a claim. Second, the defendant Eldon C. Beller ["Beller"] has moved to dismiss for failure to plead fraud with particularity and for failure to state a claim. Third, the defendants Peat, Marwick, Mitchell & Co. ["Peat, Marwick"] and Marshall Snipes ["Snipes"] have moved to dismiss for failure to state a claim or, alternatively, for summary judgment under Federal Rule 56(b). For the reasons set forth below, these motions are granted in part and denied in part, but the plaintiffs may, in certain instances, amend their complaint to cure its deficiencies.

## I.

It is well established that a complaint should not be dismissed for failure to state a claim upon which relief can be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). In

the context of a motion to dismiss, the Court must construe the challenged pleading in the light most favorable to the plaintiffs and must accept as true all well-pleaded factual allegations and reasonable inferences therefrom, but must disregard all legal or unsupported conclusions. *Mitchell v. King,* 537 F.2d 385, 386 (10th Cir. 1976). Further, the complaint should not be dismissed merely because the plaintiffs' allegations do not support their stated legal theory, for the Court is obliged to determine whether the allegations support relief on any possible theory. *Perington Wholesale, Inc. v. Burger King Corp.,* 631 F.2d 1369, 1375 n.5 (10th Cir. 1980) (citing 5 C. Wright & A. Miller, *Federal Practice and Procedure* § 1357 (1969)).

II.

DINB has moved to dismiss the action as a whole as against it. In support of its motion, DINB argues that the plaintiffs erroneously seek relief against it as successor to the failed Penn Square Bank, N.A. This argument is valid only in part.

Clearly, DINB is not the failed Bank's successor. The Federal Deposit Insurance Corporation ["FDIC"] was appointed the Bank's receiver by the Comptroller of the Currency pursuant to 12 U.S.C. §§ 191, 1821(c). DINB, in contrast, is a new bank created solely to assume and distribute the closed Bank's insured deposits pursuant to 12 U.S.C. § 1821(h)-(1). *Mahan v. Penn Square Bank, N.A.,* No. CIV-82-1745-T (W.D. Okla. March 29, 1983) (order granting partial summary judgment). Therefore, claims against the failed Bank are properly brought against the FDIC as receiver; claims for deposit insurance are properly brought against DINB (or the FDIC in its corporate capacity). *Id.* at 4 & n.2.

However, in certain counts the plaintiffs do in fact seek a judgment for deposit insurance, at least in the alternative; those counts do state claims for relief against DINB. On the one hand, Counts I through III are legally sufficient. These are contract claims involving alleged breaches of the interest reserve provisions of three separate loan agreements with the plaintiffs Windon Third, Windon Fourth, and Windon Fifth. As a remedy, the plaintiffs seek specific performance of these

agreements or, alternatively, the interest reserves themselves as insured deposits. Complaint, demands for relief "A", "B" (March 17, 1983). On the other hand, Counts IV and VI are legally insufficient. These are fraud claims in which the plaintiffs allege that Penn Square Bank and its agents, among others, made misrepresentations of fact or omitted material facts or both in connection with the individual plaintiffs' initial purchases of their limited partnership interests and the partnerships' subsequent hiring of Clifford Resources International ["CRI"] as driller and operator or their wells. These claims lie against the FDIC as receiver, not DINB.

In its reply brief, DINB contends that the interest reserves are not insured deposits under 12 U.S.C. § 1813(l), (m), citing *Federal Deposit Insurance Corp. v. Continental Illinois National Bank & Trust Co.*, 245 F.2d 567 (7th Cir. 1957). This is an interesting contention, but it is premature. DINB may be able to prove factually either at trial or by motion for summary judgment that the interest reserves are not insured within the statutory definition, but it cannot prevail on a motion to dismiss, because, as indicated above, the allegations in the complaint must be construed in favor of the plaintiff. Section I, *supra*. *Continental Illinois* is therefore inapposite. First, factually, it involves a complicated "contract reserve" quite unlike the interest reserve in the case at bar. *See Continental Illinois, supra*, 245 F.2d at 574. Second, procedurally, it is an appeal from a decision on the merits after a trial to the bench, not an order of dismissal. *Id.* at 569.

## III.

Next, the defendants Beller, Peat, Marwick, and Snipes raise a number of related arguments with regard to Count VI, the federal securities law claim: that there is no implied private cause of action under Section 17a of the Securities Act of 1933 ["the 1933 Act"], 15 U.S.C. § 77q; that for a number of reasons the plaintiffs fail to state a claim under Section 10b of the Exchange Act of 1934 ["the 1934 Act"], 15 U.S.C. § 78j and Rule 10b-5 promulgated thereunder, 15 C.F.R. § 240.10b-5 (1983) ["Rule 10b-5"]; and that the allegations of fraud are not sufficiently particular. These arguments are well taken.

**A.**

First, there is no implied private cause of action for a violation of Section 17a of the 1933 Act, so that claim must be dismissed altogether. The Tenth Circuit has not confronted this issue, *see Woods v. Homes & Structures of Pittsburg, Kansas, Inc.*, 489 F.Supp. 1270, 1284 (D. Kan. 1980), and the Supreme Court has expressly reserved decision on it, *Herman & Maclean v. Huddleston*, 51 U.S.L.W. 4099, 4100 n.2 (U.S. Jan. 24, 1983); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 n.15 (1975). However, in this District the matter is settled. *Samuel v. Tower Oil and Gas Co.*, No. CIV-81-1645-E (W.D. Okla. Sept. 10, 1982). (Memorandum Opinion 4); *Williams v. Nutritional Associates, Ltd.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,678 at 98,562-64 (W.D. Okla. June 24, 1980); *Freeman v. McCormack*, 490 F.Supp. 767 (W.D. Okla. 1980).

**B.**

Second, the plaintiffs have failed to state a claim under Section 10b of the 1934 Act and Rule 10b-5. This claim is insufficient for a number of reasons. Principally, it is not at all clear who is suing or for what; making sense of the plaintiffs' pleading is like wandering in a Daedalian labyrinth.[1] As such, the defendants are not even given the minimal notice required by the federal pleading rules. *See* Fed. R. Civ. P. 8(a), (e), (f). Moreover, the plaintiffs have not stated their allegations of fraud with sufficient particularity, both as to this Count and as to Count IV. *See Todd v. Oppenheimer and Co.*, 78 F.R.D. 415, 420 (S.D.N.Y. 1978); Fed. R. Civ. P. 9(b).

Additionally, as a matter of law, only certain of the plaintiffs have actionable claims, assuming for the purpose of

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[1] Count VI is brought by all the plaintiffs against all the defendants, seemingly for fraud in connection with the individual plaintiffs' purchases of their limited partnership interests. Complaint ¶¶ 76-80. But there are also allegations of fraud regarding the limited partnership plaintiffs' contract with CRI. *Id.* ¶¶ 68, 74. The former may be "securities" within the purview of the 1934 Act, *see, e.g., In re Longhorn Securities Litigation*, 573 F.Supp. 255, 265-66 (W.D. Okla. 1983), but the latter certainly do not appear to be.

argument that there are any good claims at all. In order to state a 10b-5 claim, one must be an injured purchaser or seller of a security.[2] *Blue Chip Stamps, supra,* 421 U.S. 723. In the case at bar, only the individual plaintiff-investors have such a claim, for it is alleged that they paid more for their limited partnership interests than they were really worth as a result of the alleged fraud. Complaint ¶ 80.[3]

In response, the limited partnership plaintiffs assert that they, too, have a 10b-5 claim as defrauded sellers. Plaintiffs' Memorandum in Opposition to the Peat, Marwick and Snipes Motion to Dismiss 5 (June 16, 1983). This assertion is disingenuous at best. Accepting as true the individual plaintiff-investors' allegation that they purchased their limited partnership interests for more than they were actually worth, *supra,* the limited partnership plaintiffs cannot have been injured, so they have no claim. Logically, there can be injury on only one side of the buy-sell relationship. Either the purchaser pays too much, or the seller receives too little (relative to actual value had the fraud been known). These two possibilities are mutually exclusive.

Finally, even the individual plaintiff-investors do not state a legally sufficient 10b-5 claim. As to Peat, Marwick and Snipes, the alleged omissions do not appear to be "in connection with" the individual plaintiffs' purchases of their limited partnership interests, but at best with the partnership plaintiffs' retention of CRI as driller and operator (which is the subject of Count V). Further, again as to Peat Marwick and Snipes, the individual plaintiffs do not allege that they relied on Snipes' statements or even that they knew of them; instead, the plaintiffs merely allege that Snipes made statements and

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[2] This problem can be analyzed either as a failure to state a claim or as a lack of standing to sue. But in both instances, the conclusion is the same.

[3] This reasoning applies with equal force to Counts IV and V, the common law claims for fraud in the limited partnerships' contract with CRI. In order to state such a claim, a plaintiff must have been injured by the allegedly actionable misrepresentation or omission. *E.g., State ex rel. Southwestern Bell Telephone Co. v. Brown,* 519 P.2d 491, 495 (Okla. 1974). As to these counts, only the limited partnership plaintiffs have claims for relief. *See* Complaint ¶¶ 51, 61.

omitted others to "plaintiffs' representative". Complaint ¶¶ 69(D), 73.

## IV.

Lastly, Peat, Marwick and Snipes have also moved to dismiss Count V, the common law fraud claim, for lack of subject matter jurisdiction under Federal Rule 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The former basis is compelling; consequently, Count V must be dismissed.

It is a fundamental principle of American constitutional law that federal courts are courts of limited jurisdiction. *See* U.S. Const. art. III, § 2. *See generally* 13 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 3522 (1975 & Supp. 1982). The party bringing an action before a federal court, therefore, has the burden of pleading the grounds upon which the court's jurisdiction depends. Fed. R. Civ. P. 8(a)(1). The plaintiffs allege in Count V that the Court has jurisdiction under 28 U.S.C. § 1332, as there is diversity of citizenship among the parties and that the amount in controversy exceeds $10,000.00. Complaint ¶ 53. In order for there to be jurisdiction under Section 1332, there must be complete diversity, that is, the citizenship of each plaintiff must differ from that of each defendant. *Strawbridge v. Curtiss,* 7 U.S. (3 Cranch) 267 (1806) (Marshall, C. J.). Where, as here, one of the parties is a partnership, the citizenship of each of its partners must be considered in determining whether there is complete diversity. *Great Southern Fire Proof Hotel Co. v. Jones,* 177 U.S. 449, 456 (1900) (Harlan, J.).

Applying these well established rules to the instant case clearly reveals that there is not complete diversity. On the one hand, the defendant Snipes has submitted an uncontroverted affidavit in which he represents that Peat, Marwick is a partnership engaged in the practice of accountancy whose partners reside and maintain offices in Pennsylvania, New Jersey, New York, Massachusetts, and Florida. Affidavit ¶ 2 (May 2, 1983). On the other hand, the Windon limited partnerships have their principal places of business in Pennsylvania, and their limited partners reside in, among other places,

Pennsylvania, New Jersey, New York, and Massachusetts. Complaint ¶¶ 1-5.

In opposition, the plaintiffs maintain that, despite the lack of diversity jurisdiction, there is pendent jurisdiction under *United Mineworkers of America v. Gibbs,* 383 U.S. 715 (1966). If both a state law claim and a federal claim "derive from a common nucleus of operative fact" and are such that the plaintiffs "would ordinarily be expected to try them all in one judicial proceeding", there is judicial power to hear the entire "case". *Id.* at 725. However, the plaintiffs' federal securities law claim against Peat, Marwick and Snipes has been dismissed, and the remaining federal claims and this claim do not derive from a "common nucleus of operative fact". Therefore, there is no pendent jurisdiction sufficient to support Count V, and it must be dismissed.[4] *See id.* at 726 & n.16.

Accordingly, DINB's motion to dismiss is granted as to Counts IV and VI, but denied as to Counts I through III; Peat, Marwick and Snipes' motion to dismiss is granted, both as to Count V and as to Count VI; and Beller's motion is granted as to Count VI. However, as to Count VI, the plaintiffs shall have ten (10) days within which they may amend their complaint, if of course they are able to do so consistent with Rule 11. Fed. R. Civ. P. 15(a). The defendants need not answer until ten (10) days after the time at which the plaintiffs shall have amended, if they elect to do so.

The Clerk of the Court is directed to mail a copy hereof to counsel of record.

DATED this day of March, 1984.

LUTHER B. EUBANKS
United States District Judge

Entered in Judgment docket
on 3-1-84

[4] If the plaintiffs are subsequently able to amend their complaint to state a federal securities law claim against these defendants, though, then there would be pendent jurisdiction over this state law claim.

HERBERT J. ROWE, ANN MUTER ROWE AND CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO, as Trustees under the Will of Leslie F. Muter, Deceased; HERBERT J. ROWE and ANN MUTER ROWE, Plaintiffs, v. MAREMONT CORPORATION, Defendant

**No. 77 C 2837**

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

**Slip Opinion**

**June 3, 1986**

**OPINION BY: GETZENDANNER**

**OPINION:**

## MEMORANDUM OPINION AND ORDER

SUSAN GETZENDANNER, District Judge:

This securities action, brought under Rule 10b-5 of the Securities Exchange Act of 1934, 15 U.S.C. @ 78b, and principles of pendent jurisdiction, is before the court for entry of findings of fact and conclusions of law in accordance with Fed.R.Civ.P. 52(a). The matter, initially filed as a cross-claim, is all that remains of the action, and was tried to the bench over a five day period in August of 1983, with additional testimony given in January of 1984. Post-trial memoranda were prepared and filed thereafter. For the reasons set forth herein, the court finds by a preponderance of the evidence in the plaintiffs' favor on their securities claim and awards damages of $745,423.80 plus interest.

## FACTS

The claim at issue grows out of a face-to-face transaction in July 1977 whereby Maremont purchased 216,965 shares of stock in Pemcor, Inc. owned by plaintiffs. The basic issues at trial were (1) whether Maremont misrepresented and knowingly concealed its intention to use their stock as a springboard for a control acquisition, and (2) whether Maremont misrepresented and knowingly concealed the existence of an FTC order which created certain legal complications in the deal. The following factual summary is intended to represent the court's recitation of both undisputed facts and disputed facts as I have resolved them based on the preponderance of the evidence presented at trial. The court heard live testimony from various of the plaintiffs' representatives and from one of Maremont's employees. Defendant did not call any of its own witnesses but did introduce designated deposition testimony into evidence. References to trial testimony and deposition testimony are accordingly noted.

### Pre-Negotiation Background

Plaintiff Herbert J. Rowe is a former Chairman of the Board, President, and Chief Executive Officer of the Muter Company, which merged with the Potter-Englewood Corporation on June 30, 1971 to become Pemcor, Incorporated. During all times relevant herein, Pemcor was a publicly held Delaware corporation which manufactured and distributed electrical products, including stereo speakers sold primarily for installation in automobiles. Mr. Rowe was Chairman of the Board and an officer of Pemcor from June 30, 1971 to July 1975. From August 1974 to January 1978 Mr. Rowe was employed by the National Aeronautics and Space Administration ("NASA"). (Stipulation of Uncontested Facts, PP 1, 3).

Plaintiff Ann Muter Rowe is the wife of Herbert J. Rowe and a daughter of the late Leslie F. Muter, founder of the Muter Company. The Rowes reside in McLean, Virginia.

Plaintiff Continental Illinois National Bank and Trust Co. of Chicago is a national banking association located in Chicago, Illinois, and brings suit along with the Rowes in its capacity as a co-trustee under the Will of Leslie F. Muter (the "Muter Trust"). Mrs. Rowe is the life income beneficiary under the trust and her children are the remainder beneficiaries. (Stipulation, PP 4-5).

Among the assets in the trust as of early 1977 were 216,965 shares of Pemcor stock; the Rowes also owned 8,921 shares of Pemcor in their individual capacity. These shares together comprised 11-½% of Pemcor's outstanding stock, and will hereafter be referred to as the "Rowe shares" or the "Rowe block." Although Pemcor was listed on the New York Stock Exchange, the Rowe shares were not registered under the Securities Act of 1933 and therefore could not be sold in the open market. The shares were further subject to an agreement dated June 30, 1971 between the Rowes and Potter-Englewood Corporation. (Trial Exhibit 1). This agreement required, as a precondition to any disposition of the stock, notice to Pemcor and an opinion of counsel selected by Pemcor that sale of the stock would not violate the 1933 Act. (Stipulation @ 6).

By early 1977 the Rowes, no longer involved with Pemcor as insiders, had decided to sell their Pemcor shares in order to diversify the Trust holdings. (A Rowe Tr. 65; Hoovel Tr. 330-332). The Rowes explored both the possibility of a private placement and a secondary public offering, and contacted various investment bankers. (A. Rowe Tr. 158-61; H. Rowe Tr. 881-83; Fuchs Tr. (1048-51). The bankers were unable, however, to locate a private placement purchaser. (H. Rowe Tr. 889).

On or about July 7, 1977, the Rowes wrote a letter to Edward F. Anixter, the president and chief executive officer of Pemcor. (Trial Ex. 83). The letter informed Anixter that the Rowes had decided "to sell all or substantially all" of the Rowe block. In the letter, the Rowes requested either that the restrictive legend on the stock be removed so that the shares could be sold without prior consent of Pemcor, or that Pemcor cooperate with a secondary offering. In particular, the letter

asked if Pemcor would prepare required registration statements and absorb such costs of the offering as would be appropriate. Anixter refused to remove the restrictive legend, but agreed to discuss the offering at Pemcor's July 22, 1977 annual board meeting. (Anixter Tr. 775-76; Kaufman Dep. 18). The Rowes had been advised at this time that an offering price at $5 to $6-½ per share was possible, that the offering would take five or six months, and that offering expenses could range from $100,000 to $250,000. (Trial Ex. 70, p. 12; Ex. 80, p. 13; H. Rowe Tr. 1032, Fuchs Tr. 1051). At this time Pemcor stock was trading on the market at around $12-13 per share (Trial Ex. 136).

Around the same time that the Rowes were considering how to dispose of their Pemcor stock, Maremont Corporation, a publicly held Delaware corporation which manufactures and distributes automotive exhaust systems and shock absorbers, was interested in expanding operations through an acquisition program. In late 1976 or early 1977, Maremont retained the services of Skadden, Arps, Meagher & Flom, a New York law firm which specializes in mergers and acquisitions. In January 1977, Maremont, acting through its president Richard Black, executed a commission agreement with The Illinois Company, a Chicago brokerage firm. (Trial Ex. 4). The Illinois Company recommended Pemcor as an acquisition candidate and arranged a meeting between executives of the two companies. In anticipation of the meeting, Maremont prepared a series of "acquisition analyses," all of which examined the impact that a 100% purchase of Pemcor would have on Maremont's growth and earnings. (Trial Exs. 6-16; Williams Dep. (11/2/77) 47-48; Black Dep. 114, 119-22; [illegible]ulation P 12).

The first Pemcor-Maremont meeting occured on March 8, 1977. Present at the meeting were Black; Jerry Williams, Maremont's Vice-President of Corporate Planning and Business Systems; William Penner and Tom Gordon of The Illinois Company; Pemcor president Anixter; and Henry Kohorn, Pemcor director. The meeting apparently remained cordial but no conclusive agreements were reached.

A second meeting was held between Black and Anixter alone on April 29, 1977. (Black Dep. 173-74, 180-83; Anixter

Tr. 724-25). Anixter promised to get back to Black at some point in the future. Black testified at his deposition that he hoped Anixter would agree to some merger or affiliation after the meeting. (Black Dep. 166-67). Anixter, however, was not interested in a merger at this time, and made no effort to contact Black. (Anixter Tr. 723). In consequence, Maremont, although still interested in a combination with Pemcor, ceased active consideration of Pemcor as an acquisition candidate. (Mills Tr. 585-588).

On or about July 13, 1977, The Illinois Company informed Black of the possible availability of the Rowe block. Black instructed Williams to update the earlier acquisition analyses, arranged for Skadden, Arps to handle the transaction, and obtained approval from the Maremont board to purchase the Rowe block. (Black Dep. 132-33, 148-49, 177-78, 201, 208-211, 280-282; Williams Dep. 11/2/77 146-48; Mills Tr. 599). Black's intent at this time, as it had been before, was "to explore with Mr. Anixter and/or the Directors the possibility of Maremont acquiring . . . control of Pemcor." (Black Dep. 132).

After receiving Williams' update and the directors' approval, Black instructed Penner to proceed. (Black Dep. 218-19). Pursuant to this instruction, on Monday July 18, 1977, Gordon Teach of The Illinois Company contacted Darryl Hoovel, an investment officer in the trust division of Continental and offered on behalf of an undisclosed principal to purchase the Rowe shares for the closing market price on that date of $13 per share. Hoovel conveyed the offer to Gordon Martin, another Continental officer, who in turn conveyed the offer to Mrs. Rowe at her home in McLean, Virginia, and to the Rowes' attorney in Chicago, Robert Fuchs.

All parties agreed that the price was very good. The stock was in fact at an all time historical high, and the market price had doubled since January of 1977. (Ex. 136). However, because of the necessary investment representations involved in the sale of restricted stock and because of Mrs. Rowe's long ties with Pemcor, she refused to sell the Rowe shares "blind," i.e., without knowing the name of the purchaser. Mrs. Rowe phoned Teach and arranged to come to Chicago the next day to

meet him, thus beginning the first of three days over which the Rowes and/or their representatives met with representatives of Maremont corporation to arrange for the sale of the stock.

## THE ROWE-MAREMONT NEGOTIATIONS JULY 19, 1977 MEETING.

On Tuesday, July 19, 1977, Mrs. Rowe met at Continental Bank with Teach, Fuchs, Hoovel and Martin. She had with her a written authorization to act on behalf of her husband as co-trustee. At this meeting, Teach revealed Maremont's name only after Mrs. Rowe insisted on knowing the purchaser and after he had obtained Maremont's approval. Teach also requested that the Rowes not disclose Maremont's name to anyone else until 24 hours after the agreement was reached. (Trial Ex. 25, p. 2).

Mrs. Rowe, upon learning Maremont's name, remarked that the two companies would make a "good fit" because of their combined expertise in the automotive business. (A. Rowe Tr. 87; Hoovel Tr. 340). Teach informed the Rowes that Maremont had recently sold one of its divisions, that it wanted the shares for investment purposes, and that it intended to purchase enough Pemcor stock to get a director of its choosing elected to the Board. Mrs. Rowe informed him that the Rowe block would not assure election of a director, because her own efforts to name herself as a Pemcor director had failed. Teach responded by saying that Maremont knew that and intended to buy "up to" or "as much as" twenty percent. Teach also mentioned two Pemcor directors with whom Maremont was negotiating additional purchases. (Hoovel Tr. 207-08; Trial Ex. 137-A, p.3). Teach never promised, however, that Maremont would cease its purchases of Pemcor at 20%.

At the close of the meeting, Mrs. Rowe agreed to sell the Pemcor shares to Maremont at $13 a share, the closing price from the day before, less a ⅛ commission to be paid by the Rowes to The Illinois Company. (A. Rowe Tr. 94; Fuchs Tr. 1193). At some point during this meeting she indicated that she wanted to avoid controversy. (A. Rowe Tr. 89). There was no testimony, however, as to the exact context in which that

statement was made, and the statement was apparently neither repeated nor emphasized.

Teach was anxious to finalize the deal that day, as he was going on vacation. However, further documentation was necessary before the deal could be closed. In particular, the Rowes were bound under the 1971 agreement to notify Pemcor before any sale of the stock, and to enable counsel chosen by Pemcor to determine that such transfer would not require registration under the 1933 Act. This required in turn that Maremont make certain investment representations, i.e., that it was not buying the stock with a view to a subsequent disposition in the market. Teach informed the Rowes that William Penner would substitute for him at the next day's meeting. Mrs. Rowe returned to Washington, and Fuchs began drafting the appropriate documents.

July 20-21, 1977. The next day, the following people met at Fuchs' office to negotiate the sales agreement: Fuchs; Marvin Temple, an associate in Fuchs' law firm; William Penner of The Illinois Company; Jack Mills, Maremont's General Counsel; Maremont Vice-President Jerry Williams; Milton Shapiro, Maremont's Treasurer; and David McDonald, a lawyer for The Illinois Company. Of the Maremont representatives, only Williams had known about Maremont's interest in acquiring Pemcor from its inception. Shapiro first heard of Pemcor sometime earlier that week. (Shapiro Dep. 15-18). Mills had learned of Pemcor the week before when he had been asked by Black to inquire into the possible effects of an FTC order on Maremont's purchase of Pemcor stock. (Mills Tr. 568, 604).

Early that morning, Shapiro and/or Penner repeated Teach's statement that Maremont intended to make an investment in Pemcor stock with the cash available from the sale of a division, that it was negotiating with other Pemcor directors to purchase the stock, and that it wanted to elect a director to Pemcor's board (Temple Tr. 904, 912; Fuchs Tr. 1102). Maremont had in fact recently sold its Spalding division for about $3,000,000 in cash, approximately one and one-half times the Rowe purchase price, (Mills Tr. 642), but there is no evidence that excess cash had anything to do with Maremont's

motives in acquiring Pemcor. Shapiro further represented at some point during this meeting that the funds would be wire transferred from California, even though the funds for the purchase were taken from Maremont's revolving credit account with Continental Bank here in Chicago. (Compare Rowe Tr. 682-83 and Fuchs Tr. 1107 with Ex. 54 p.2). The twenty percent figure was again mentioned as well. (Temple Tr. 904).

Black testified at his deposition that the 20% figure was in fact a "fallback position" for him because a 20% investment would guarantee Maremont's ability to consolidate Pemcor earnings for accounting purposes should a merger fail to materialize. (Black Dep. at 128, 130). Williams and Black had discussed how the Rowe purchase "wasn't going to be much of an investment" absent additional purchases "to take it to the balance sheet" (Williams Dep. 155-56), and Penner had advised that the available shares from the other directors might reach that figure. (Black Dep. 300-01). None of Maremont's representatives, however, remembered any statements to the Rowes about a possible 20% acquisition, (Williams Dep. 243; Shapiro Dep. 206; Pirie Dep. at 109-11), and counsel's trial position was simply that the 20% figure was never mentioned as a limit. There is no evidence to support the statement that Maremont wanted enough stock to elect a director of its choosing to the Pemcor board.

As the negotiations continued, Penner, McDonald, and Williams all left the meeting; sometime later that afternoon, Robert S. Pirie and Milton G. Strom, attorneys with the Skadden, Arps firm, arrived to handle the transaction for Maremont. Shapiro introduced Pirie and Strom as New York lawyers who were in Chicago on other Maremont business and were "stopping by" to help Maremont conclude the transaction. (Temple Tr. 904-05; Fuchs Tr. 1102). In fact, the attorneys had been asked to handle the Rowe transacton specifically in connection with a possible Maremont-Pemcor acquisition. (Black Dep. 280-282; Williams Dep. (11/2/77) 146-48; Mills Tr. 599; Pirie Dep. 29-31; Strom Dep. 7-10; Exs. 26-27). Shapiro admitted at his deposition that he "might have" referred to Pirie and Strom as just stopping by. (Shapiro Dep. 224). Herbert Rowe, who had been in Missouri on business for

NASA, arrived sometime later that afternoon. (H. Rowe Tr. 675).

The Rowes knew that Maremont wanted to close the deal rapidly. (H. Rowe Tr. 674). The Rowes could not close, however, because the 1971 merger agreement gave Pemcor's counsel control over the issuance of the opinion letter. To solve this problem, Fuchs drafted an escrow agreement which would lock in the $13 price, commit the parties to the deal, but delay actual "closing" until Pemcor had had an opportunity to issue an opinion letter. (H. Rowe Tr. 837, Temple Tr. 959; Fuchs Tr. 1221; Pirie Dep. 71-74). The term of the escrow as originally provided was two years. The purpose of the extended term was to accommodate possible delay or "heel-dragging" by Pemcor in issuing the opinion letter. (Temple Tr. 962-63; Fuchs Tr. 1109; H. Rowe Tr. 839-40). The Rowes and their representatives all testified that they expected to have the opinion letter within a short time since they knew of no legitimate grounds on which Pemcor could argue that the sale did not comply with the SEC laws. (H. Rowe Tr. 687-88, 690; Fuchs Tr. 1109). The New York lawyers, Pirie and Strom, however, both testified to the impression that the Rowes' relations with Pemcor were bad, and that the Rowes were afraid of substantial delay. (Pirie Dep. 73, 112-13; Strom Dep. 37-38).

Neither Maremont nor Herbert Rowe was happy with the two year escrow. (Pirie Dep. at 73-74; H. Rowe Tr. 834-35; Fuchs Tr. 1109). Fuchs threupon drafted a proposal that each side be allowed to terminate the escrow if the opinoin letter still hadn't issued after six months. (Ex. 87). Maremont, which would have been ready to pay cash had control over the opinion letter not been vested in Pemcor refused. Ultimately it was settled that Maremont could withdraw after six months and the Rowes after nine. (Pirie Dep. at 73-74; Trial Exhibit 31). Mr. Rowe recalled agreeing to the discrepancy at Fuchs' urging. (H. Rowe Tr. 838).

With respect to the escrow, Maremont also insisted on being given the unilateral option to take possession of the Rowe shares after August 1, 1977. (Ex. 30, P 10). Maremont would not yield to the Rowes' request for similar rights, but agreed to

indemnify the Rowes should litigation arise with Pemcor following exercise of that option. (Ex. 31; Pirie Dep. 117-121).

Herbert Rowe stayed overnight in Chicago. On the morning of July 21, he met for breakfast with Anixter to inform Anixter of the impending private placement and to tell Anixter that there was thus no need for the Pemcor board, at its annual meeting the next day, to act on the Rowes' requested secondary offering. As agreed upon with Maremont, Rowe did not disclose the name of the purchaser to Anixter. (Rowe Tr. 705; Anixter Tr. 728, 755). Rowe was also to ask Anixter to cooperate in issuance of the opinion letter. Anixter, however, recalled no such request. (Tr. 728).

At that meeting, Anixter attempted to dissuade Rowe from selling until after the company announced its earnings at the annual meeting, but Rowe refused on the ground that he had already made a deal and was going to stick with it. (Anixter Tr. 728, 756). Anixter recalled on cross-examination saying to Rowe that any company interested in purchasing 11-½% would probably want to buy the rest of Pemcor, to which Rowe made no reply. (Anixter Tr. 751-53). Rowe did not recall this remark. (H. Rowe Tr. 836).

Rowe recalled Anixter asking if there was going to be a takeover, to which Rowe responded that he had been told that the buyer intended to purchase only up to 20% of the stock. (H. Rowe Tr. 872). Anixter, however, remembered that Rowe made no response to his question about a probable takeover, and said nothing about a 20% interest or about the purchaser wanting a director on the Pemcor board. (Anixter Tr. 753-55). Anixter testified that the first he heard of a 20% limit was at his deposition in this action. (Id. at 750-54).

Upon returning to Fuchs' office, Rowe did not tell the Maremont representatives about his meeting with Anixter. He did point out to Maremont that the stock had risen over a point and a half since Monday's closing price (Wednesday's closing price had been at 14.6). (Trial Ex. 136). Rowe stated, however, that he was still satisfied with the deal at $13. Pirie interpreted this remark as indicating that Rowe did not care what Maremont did in the future with its Pemcor stock. (Pirie

Dep. 108). There was no questioning by or of either Mr. Rowe or Fuchs as to what might have been causing the rise in price.

Maremont's future intentions with regard to Pemcor were, however, discussed at least once. Although the testimony is in sharp dispute, the court finds that at some point on either July 20th or 21st, Marvin Temple asked Milt Shapiro whether Maremont was going to make a tender offer, and Shapiro answered "No." (Temple Tr. 907-08; Fuchs Tr. 1105). Although both Temple and Fuchs recalled this question and response in the presence of others, neither Herbert Rowe nor most of the Maremont representatives, including Shapiro, remembered any discussion about a tender offer at the meetings. Jack Mills remembered Temple asking him when and not whether Maremont would make a tender offer, and that he (Mills) made no reply. (Tr. 635). Mills remembered this question occurring only when all the documents had been signed at the bank; Temple, however, was not present at that time, so at the very least Mills misremembered the timing of the question.

## THE FTC DECREE AND THE ANTITRUST REPRESENTATIONS

At all times relevant to this litigation, Maremont was subject to the terms of an FTC consent order which prohibited Maremont from acquiring the whole or any part of the stock of any company "engaged in the manufacture or remanufacture or the wholesale distribution of automotive replacement parts, accessories, or equipment" without prior FTC approval. This decree was entered pursuant to an administrative complaint filed against Maremont under the Clayton Act. The decree was a matter of public record, and is described in Maremont's 1976 Annual Report. (Ex. 112 at 23).

When Maremont president Richard Black first learned of the Rowe shares, he directed Joe B. Freeman (Maremont Executive V-P) and John Mills (General Counsel) to inquire whether the order would bar acquisition of Pemcor stock. Since Pemcor was in the business of manufacturing car stereo speakers, the issue was whether such speakers fell within the defini-

tion of "automotive replacement parts, accessories, or equipment" as defined in the decree.

Freeman's investigation of the matter consisted of asking Jean Allard, an attorney with the Sonnenschein law firm in Chicago and a Maremont director, whether the order applied to a company which manufactured hi-fi components used in original equipment installation of automobiles. Freeman said he did not know the degree to which the company sold replacement equipment. (Allard Dep. 19). Allard informed him that there would be no problem if the company (which was Pemcor) in fact sold only for original installation. (Id. at 21). After checking with Sonnenschein partner Earl Pollock, who had been involved in the FTC proceedings, she asked Freeman for further information. (Id. at 26). Freeman sent her the Pemcor annual report, some SEC filings, and other financial information, none of which indicated to her that Pemcor was involved in the automotive replacement market. (Id. at 32). In fact, the Jensen automotive speaker manufactured by Pemcor is sold as an accessory in the after market for installation in automobiles (as opposed to the original equipment market). (Stipulation P1).

Based on her understanding that Pemcor sold only to original equipment installers, Allard advised that prior FTC approval was not required. She did, however, caution that Maremont could expect a "challenge" from the FTC. This information was conveyed to Black and Williams in a memorandum dated July 18, 1977. (Ex. 24).

Mills began his investigation by obtaining information about Pemcor from Williams, and called Earl Pollock, who told Mills that his initial reaction was that the decree would not apply. Pollock also advised, however, that he hadn't examined the question enough to issue a written opinion. (Mills Tr. 594). No outside lawyer ever advised Maremont that the FTC decree would bar the transaction with the Rowes. (Mills Tr. 633). The issue remained open in Mills' mind, however, so much so that he asked Herbert Rowe at the July 20th meeting several questions about Pemcor's distribution system. He did not inform Rowe of his concern behind the questions. (Id. at 611-612)..

The FTC decree was never discussed at the meetings between Maremont and Rowe representatives. The initial draft of the investment representations prepared by Fuchs contained a clause in which Maremont would "warrant and represent that we are not in competition with Pemcor." Edwin Goldberger, an attorney with D'Ancona & Flaum whom Fuchs had contacted, had recommended to Fuchs that this language be modified to incorporate Clayton Act language dealing with vertical integration instead. (Fuchs Tr. 1101, Goldberger Tr. 1374-76). Prior to Pirie's arrival, Mills had agreed to include the original language but not the Clayton Act language. (Fuchs Tr. 1101-02).

After Pirie arrived, he objected to including this language because he said everyone is in competition for the consumer dollar. Pirie had been informed by Freeman of the FTC order's existence upon his arrival in Chicago but had also been told that outside counsel had advised that it wouldn't apply. (Pirie Dep. 50-51). Pirie testified that he was of the impression that Sonnenschein had signed off on an opinion (id. at 53) and considered that the FTC decree a non-problem. (Id. at 98). He further testified that had he thought otherwise, he would not have let Maremont spend its money on the stock. (Id. at 134).

When Pirie objected to the no competition representation, Fuchs asked whether there were any antitrust problems. (Fuchs Tr. 1106; Mills Tr. 610; Temple Tr. 906-07). Pirie answered that he knew of none. (Mills Tr. 610; Temple Tr. 906-07; Fuchs Tr. 1106; Pirie Dep. 50-52, 57, 139-41). Mills testified that he thought of the FTC order at this time but said nothing. (Tr. 610-11). Based on Pirie's representation, Fuchs agreed to drop the antitrust language from the agreement, and the final draft was silent on the antitrust problems.

After the Rowe negotiations had concluded, Mills inquired of Bill Pelster, an attorney with Skadden, Arps, as to whether the order applied. Pelster, after looking into the matter, advised that the FTC decree would not bar the transaction for a reason somewhat different than that relied on by Allard: namely, that the term "automotive replacement parts" as used in the decree was defined in accordance with the Department of

Commerce's standard industry classifications, and that Pemcor's stereo speakers fell under a different classification number. (Pelster Dep. 22, 25; Ex. 41).

**The Final Agreement**

At the close of the afternoon on Thursday, July 21, the Rowes and Maremont had agreed on final forms of the following documents: a Sale Agreement (Ex. 32); an Escrow Agreement (Ex. 31); a supplemental indemnification agreement; irrevocable proxies coupled with an interest (Ex. 35); and stock powers and certificates (Ex. 34A-D). The documents were signed by Maremont and by the Bank as trustee Thursday afternoon; Mr. Rowe then flew home with the documents and the Rowes signed them the next morning. (A. Rowe Tr. 100; H. Rowe Tr. 705). The documents were then delivered by messenger back to Chicago. (Id.)

The final draft of the escrow agreement, pursuant to the negotiations discussed earlier, provided for a two year escrow with a right of withdrawal after six months for Maremont and after eight months for the Rowes. Maremont retained the unilateral right to control distribution of the escrow, and a separate indemnification agreement ensured that the Rowes would be reimbursed for their legal expenses if Maremont exercised its contractual right to take possession of the shares before Pemcor issued its opinion letter.

The final draft of the sales agreement contains, among other things, Maremont's representation that the sale was in compliance with Section 4(1) of the Securities Act of 1933: "[W]e represent and warrant" that "we have not offered or sold the stock within the meaning of the Act," and that "we are acquiring the stock for our own account for investment, with no present intention of dividing our interest with others or for reselling or otherwise disposing of [the shares] . . . in connection with, any distribution thereof." (Ex. 32 p.3). Maremont further represented that it had no "present or contemplated agreement, undertaking, arrangement, obligation, indebtedness or commitment providing for or which is likely to compel a disposition of the stock" and that it knew of no

present circumstances "likely . . . to promote a disposition." (Id.)

## MAREMONT'S POST-TRANSACTION CONDUCT

After the Rowe contract was signed, Maremont's president immediately phoned Edward Anixter to announce the purchase and suggest a further meeting between the two executives. (Black Dep. 188-190; 288-89; Anixter Tr. 729). Anixter, who was attending Pemcor's annual board meeting at the time, said he would speak again with Black over the weekend. (Black Dep. 187-89). Anixter then reported both the phone call and his prior contacts with Black to the Pemcor board. (Kaufman Dep. 25; Anixter Tr. 730-31). Some directors responded that Maremont was obviously going to make a takeover bid, and they began discussing various defensive postures. (Anixter Tr. 730-31; Kaufman Dep. 155).

On Friday, also just after the deal was closed, Milton Shapiro contacted Continental Bank to arrange for up to $30 million in financing for an acquisition of Pemcor. (Shapiro Dep. 78, 99-102, 263). Shapiro recalled mentioning to Continental that one of the possibilities being contemplated was a cash tender offer, and discussing with Continental a possible conflict of interest since Continental was Pemcor's banker. (Id. at 67, 263). Strom testified at his deposition that he spent the weekend drafting "anticipatory tender offer documents" back in New York so that Maremont would be ready to go forward quickly if necessary. (Strom Dep. 86-88; Ex. 26) Black testified, however, that he was still hoping for a friendly takeover at this date. (Black Dep. 290-91).

Over the weekend, Anixter continued to meet with other Pemcor directors and officers. (Anixter Tr. 730-33). On Sunday, July 24, he and Black again spoke by phone. (Anixter Tr. 732; Black Dep. 189-90). Anixter said he needed more time. (Id.) Black sensed Anixter's coolness, told Jerry Williams of Maremont to retain the Boston Consulting Group for investment advice, and began to consider that a hostile tender was the most likely course. (Black Dep. 190-91, 290).

On Monday, July 25, the Maremont board held its regularly scheduled annual meeting. (Black Dep. 293). Black took up to subject of Pemcor, and both Williams and Pirie made presentations regarding the purchase and Maremont's alternatives, such as holding the investment, increasing the holding to 20% for accounting purposes, making a friendly merger proposal, or launching a cash tender offer. (Black Dep. 145-46; 294-97; Williams Dep. 165; Pirie Dep. 174-75, 180; Trial Exhibits 43-44). The board approved and ratified the Rowe purchases, appointed a special committee to undertake further investigation of matters regarding Pemcor, and empowered the committee to make additional purchases of Pemcor which would increase Maremont's holdings to approximately 20%. (Ex. 44 at pp. 5-6; Black Dep. 307-308; Pirie Dep. 180).

Also on that Monday, Milton Shapiro contacted bankers at Crocker Bank and Chase Manhattan about financing the tender offer in view of Continental's conflict. (Shapiro Dep. 93-95, 104). Continental eventually decided they could not finance Maremont's hostile offer (id. at 91), and Crocker agreed to finance the takeover attempt. (Id. at 110).

By Friday, July 29, the Maremont board had given the go ahead for a tender offer, and Black sent Anixter a "bear hug" letter advising of Maremont's intent to make a cash tender offer for any and all Pemcor shares at $16.75 per share. (Ex. 46). Anixter thought Maremont's tender offer price to be "grossly inadequate" (Tr. 738) and knew that the Pemco directors, who owned significant blocks of stock, preferred remaining independent. The Pemcor board did not respond to the bear hug letter. On Monday, August 1, 1977, Maremont publicly announced its intention to make a tender offer and filed a Schedule 13-D statement in which it announced this plan, and noted that although no definitive plans had been made at the time of the Rowe purchase, the purchase had been executed "with the intention that discussions for . . . exploring the possibility of acquiring control would be sought." (Ex. 47; Ex. 54 at p. 3).

Pemcor, which had by this time discovered the existence of the FTC consent decree, vigorously opposed the tender offer.

Pemcor notified the FTC of the acquisition, and the FTC on August 2, 1977 directed Maremont to explain why the purchase did not constitute a violation of the 1971 order. (Ex. 61). On August 3, 1977, Pemcor filed the instant litigation against both the Rowes and Maremont to restrain the Rowes from transferring possession of the shares and raising the consent decree as an issue.

**The Rowes' Post-Transaction Conduct**

Immediately upon the closing of the Rowe purchase on July 22, Robert Fuchs phoned Chuck Kaufman, outside counsel for Pemcor and a member of its board of directors, to inform him of the deal and request his cooperation in connection with the opinion letter. (Kaufman Dep. 21-22; Fuchs Tr. 1119-20). Kaufman asked Fuchs whether there would be a tender offer, and Fuchs said that he had been advised there would not be. (Kaufman Dep. 66; Fuchs Tr. 1120).

The next week, on July 29, Kaufman phoned Fuchs to advise him of the FTC decree. (Fuchs Tr. 1121). Fuchs promptly phoned Shapiro and Mills to ask why he hadn't been informed about the order. (Id. at 1122-23). Both men assured him that the FTC decree did not apply to the transaction, and that Pemcor was grasping at straws. (Id.) Two days later, in response to a request from Kaufman Fuchs certified on behalf of the Rowes that "the letter agreement, the escrow instructions, the letter agreement with The Illinois Company, the indemnification letter, and the irrevocable proxy are the only agreements, instruments and understandings between our clients, Maremont and/or with any other parties relating to the Stock." The letter also requested that Pemcor promptly issue its opinion letter allowing the escrow to be terminated. (Ex. 57).

Fuchs and the Rowes all first learned of the Maremont tender offer from an article in the August 2, 1977, Wall Street Journal. (Fuchs Tr. 1129; A. Rowe Tr. 176-77; H. Rowe Tr. 796, 803-804). The Rowes told Fuchs that they wanted their stock back, and Gordon Martin of Continental phoned Fuchs to complain that they'd been "taken." (A. Rowe T. 102-05; Martin Tr. 437-39; H. Rowe Tr. 795-800). Fuchs, however,

wanted to proceed cautiously, in part because the Rowes were in California, and in part because he felt they had "moved too quickly on the first deal" and should therefore be sure of their position before taking on an adversary relationship with Maremont. (Fuchs Tr. 1131-32). He sought further counsel from the firm of D'Ancona & Pflaum, which now represents the Rowes in this litigation; however, two of the lawyers from whom he sought advice were out of town.

On August 4, Fuchs wrote to Maremont asking for their response to the matter raised in Pemcor's complaint with respect to the FTC consent order.

The letter reads as follows:

> As you know, neither this firm nor any of the prospective sellers of the shares covered by the July 21st letter agreement between our clients and you was informed either by you or by your counsel of the existence of this consent order and the potential problems it may have created. If, in fact, the effect of the order is to prohibit you from acquiring the Pemcor shares covered by the July 21st agreement, you can well appreciate that there may be some serious legal problems involved.

(Ex. 60). Nothing in the letter refers to the tender offer, the representation about the lack of antitrust problems, the 20% representation, nor any desire to rescind the sale.

On August 12, Fuchs and Temple met with Erwin Goldberger, the securities lawyer who had given them some previous advice on the antitrust matter. The decision was then made to file a cross-claim against Maremont seeking rescission and a counterclaim against Pemcor (in the alternative) on the ground that Pemcor's refusal to issue the opinion letter was "spurious" and without basis. (Goldberger Tr. 1329-32).

On August 15, Fuchs spoke with Pirie by phone; the latter offered to reimburse the Rowes for legal fees in the pending litigation. According to Fuchs' penciled note of the conversation, Fuchs asked Pirie why he hadn't informed them of the FTC order, and Pirie responded "We felt we had no obligation

to disclose." (Ex. 137-A at p.10). According to Fuchs' trial testimony, however, Fuchs also told Pirie he thought it incredible that Pirie did not disclose the fact that Maremont was obviously going to go for a tender offer, and expressed his view that the Rowes could rescind the sale. (Tr. 1130-31).

Also on August 15, 1977, the Rowes filed with the SEC a Schedule 13-D in which they listed under the heading "contracts, arrangements or understanding" only the written agreements dated July 21, 1977. (Ex. 124, Item 6). No mention was made of the representations of which the Rowes now complain, nor of any intent to rescind. At or about this time, Mr. Rowe reviewed and signed the Schedule 13-D and also reviewed Fuchs' August 4th letter to Maremont in which Fuchs complained about Maremont's concealment of the FTC order but was silent on the tender offer. (H. Rowe Tr. 807-808; 825-29). Rowe felt that the August 4th letter was "worded too graciously" but had no complaint as to substance. (Id. at 828.) When the Rowes returned home on August 18th, they found a letter from Fuchs dated August 3, with enclosed copies of an agreement to pay the Illinois Company its ⅛ point commission. (Ex. 101; H. Rowe Tr. 804-07). The Rowes signed the agreement.

By letter dated August 23, 1977, Fuchs on behalf of the Rowes formally requested rescission of the sale. In the letter, Fuchs specifically charges that Maremont and its agents violated Section 10(b) of the Exchange Act by, among other things,

> stating to the Rowes and to the Muter Trust that your purpose in acquiring their stock was solely for investment and that you planned only to obtain a number of shares of Pemcor stock (approximately 20% of the total outstanding shares) sufficient to cause the election to Pemcor's Board of Directors of one person to be designated by you when, in fact, you intended, while concealing from the Rowes and the Muter Trust that intention, immediately upon purchasing or entering into an agreement to purchase their Pemcor stock at $13.00 per share, to announce a tender offer for all of the outstanding shares of

> Pemcor stock at a cash price per share substantially in excess of that which you had paid or agreed to pay to them. You and your agents also advised the Rowes individually and as co-trustees of the Muter Trust that your reason for making the investment at that time was that, because Maremont had just sold off one of its divisions, you had ready cash available to purchase such a 20%-interest when, in fact, you intended, while concealing from them that intention, to borrow all or substantially all of the funds to purchase their shares. In addition, you and your agents and attorneys omitted to disclose to the Rowes and the Muter Trust the existence of the FTC Consent Order referred to in Pemcor's complaint in the above action when, in fact, you had represented to them that you were bound by no obligation likely to compel a disposition by you of the Pemcor stock you were purchasing from them, and that you were not aware of any circumstances then in existence which were likely in the future to compel a disposition of that stock.

(Ex. 62 p.2).

Despite the above request, the Rowes on August 30 filed their counterclaim against Pemcor, in which part of the relief requested was an order directing Pemcor to transfer the Rowe shares to Maremont. The cross-claim against Maremont was filed on October 27, 1977 and, like the rescission letter, did not mention either the no tender offer representation or the no antitrust problem representation.

**Final Disposition of the Stock**

Because of the pending litigation and FTC proceedings, Maremont did not take possession of the Rowe shares during this period and did not go ahead with its tender offer. Both Pemcor and Maremont submitted a series of memoranda to the FTC on the issue whether the 1971 consent decree required FTC approval prior to the sale of the stock from the Rowes to

Maremont. The FTC conducted no hearings nor took any evidence. On April 12, 1978, the FTC issued a one-page ruling in which it stated that the FTC order was applicable to Maremont's purchase of Pemcor stock, but then approved the proposed acquisition without discussion. (Ex. 63). On April 18, 1978, over the Rowes' objections, Continental Bank as escrow agent delivered the Rowe shares to Maremont, and credited the respective accounts of the Rowes and the Trust with a total of $2,982,605.29. (Stipulation P. 38).

On the date the escrow was distributed, Pemcor closed at 21-5/8, representing a $1,901,115 profit to Maremont. On May 25, 1978 Pemcor transferred the Rowe shares to Maremont. (Kaufman Dep. at 82-83). On that date, Pemcor closed at 23-⅞. Maremont's subsequent attempts to reinitiate merger discussions with Pemcor were rebuffed. On October 18, 1978, Pemcor merged into Esmark, and Maremont exchanged the Rowe shares for a block of Esmark stock which had a market value of $6,993,360. (Trial Exs. 75, 136). These Esmark shares were sold in August, 1979 for the sum of $7,039,439, thus representing a total gain to Maremont of $4,056,834 on its purchase of the Rowe block. (Id.) It is undisputed that after the Rowes received the payment from the escrow, they made no attempt to purchase any Pemcor stock. (A. Rowe Tr. 219).

**Legal Discussion**

In order to recover damages, a plaintiff in a 10b-5 action must prove by a preponderance of the evidence the following elements: 1) a material misrepresentation or omission, 2) made with intent to deceive, 3) which proximately caused the plaintiff's injury. *McNichols v. Loeb Rhoades & Co.*, 97 F.R.D. 331, 336 (N.D. Ill. 1982). Plaintiffs argue that Maremont violated Rule 10b-5 in the following ways:

> 1) By not disclosing its intent to pursue a control acquisition of Pemcor when it represented that it was purchasing the shares for "investment" and that its goal was only to acquire up to 20%, or enough shares to elect a director;

2) By not disclosing the FTC order despite representations that it knew of no antitrust problems and that it knew of no circumstances likely to compel a disposition of the stock;

3) By falsely denying any intent to make a tender offer when asked.

Maremont, in turn, argues that its agents never represented it would not acquire above 20% and that it would not make a tender offer, and that its agents were under no duty to disclose the FTC order or the company's future intentions. Maremont further argues that the alleged statements were not material, and that the Rowes have failed to prove reliance, scienter and damages. Before turning to the merits of these arguments as to each claim, the court will briefly address four underlying legal disputes raised in the briefs: 1) Maremont's duty to disclose; 2) plaintiff's duty to prove reliance; 3) whether reliance on nonwritten representations in this context is reasonable as a matter of law; and 4) materiality of preliminary merger discussions.

1. Duty of Disclosure.

The wrongs of which plaintiffs accuse Maremont primarily involve matters of omission. The parties have briefed and disagree on the issue of whether and to what extent Maremont was under an affirmative duty to disclose information. Plaintiffs argue that under Rule 10b-5, "when a party undertakes to disclose anything, it has the duty to speak the full truth." *Issen v. GSC Enterprises, Inc.*, 538 F.Supp. 745, 751 (N.D. Ill. 1982). Maremont, on the other hand, contends that omissions are only actionable under 10b-5 where the defendant is an insider with respect to the stock being traded or is a fiduciary of the plaintiff, *Chiarella v. United States*, 445 U.S. 222, 229-30 (1980), and points out that the cases relied on by plaintiffs involve corporate insiders subject to affirmative duties of disclosure. *See, e.g., Issen* at 751. Plaintiffs argue in reply that Chiarella's import is confined to open market transactions, not face-to-face negotiations, and that Maremont was therefore under a duty to disclose the "full truth" about its intentions.

The court disagrees with the latter statement. Under traditional principles of common law fraud, which typically inform the liability rules for 10b-5, suppression of facts is not actionable absent an affirmative duty to disclose, and plaintiffs have offered no authority for the proposition that the obligations automatically differ between open market and face-to-face purchases. Thus, to the extent that plaintiffs seek recovery on the assumption that Maremont was legally obligated to disclose all material information, their claim fails as a matter of law.

Nonetheless, this court does not view *Chiarella*'s language about relationship of "trust and confidence" as suggesting the sole way in which a duty to disclose under Rule 10b-5 might arise. At common law, a party who is under no obligation to speak as to a matter, if he undertakes to do so, is bound "not only to state the truth but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated; if he speaks at all, he must make a full and fair disclosure." *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1313 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978). Such a rule is explicit in the language of Rule 10b-5 itself, which makes it unlawful "to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ."

Numerous courts have followed *Bankshares* to hold that a party who makes a materially incomplete disclosure thereby triggers a duty under Rule 10b-5 to disclose whatever additional information is necessary to prevent the earlier statement from being misleading. See *Levinson v. Basic, Inc.,* 786 F.2d 741, 746-47 (6th Cir. 1986); *Grossman v. Waste Management, Inc.,* 589 F.Supp. 395, 409 (N.D. Ill. 1984); *Rose v. Arkansas Valley Environmental & Utility Authority,* 562 F.Supp. 1180, 1207-08 (W.D. Mo. 1983); *Marrero v. Banco DiRoma,* 487 F.Supp. 568, 575 (E.D. La. 1980); *Upton v. Trinidad Petroleum Corp.,* 468 F.Supp. 330, 337 (N.D. Ala. 1979), aff'd 652 F.2d 424 (5th Cir. 1981). At least one of these cases has further held that *Chiarella*'s language about "trust and confidence" does not change the above rule. *Rose,* 362 F.Supp. at 1207. This court

agrees. Thus, while Maremont was under no general obligation of disclosure, the Rowes may argue Maremont's omissions in connection with statements they allege are misleading because materially incomplete.

2. Reliance.

A legal question closely related to the above is whether the Rowes are under an affirmative duty of proving reliance in order to recover damages. Generally, plaintiffs bringing suit under Rule 10b-5 must prove reliance as an element of their claim. In "pure omission" cases, however, reliance and causation are presumed once materiality of the omitted statements is proven. *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 153-54 (1972). Plaintiffs therefore argue that with respect to facts that were not disclosed they are under no burden of proving reliance in this case.

Plaintiffs are wrong. As discussed at length by my colleague Prentice Marshall in *Grossman v. Waste Management, Inc.,* 589 F.Supp 395 (N.D. Ill. 1984), the *Affiliated Ute* presumption of reliance "exists primarily because of the practical impossibility of proving reliance where no statements are made," and therefore its "underlying rationale does not logically apply in a case in which the 'omissions' are the type that can be said to exist only because of other, positive statements that the [defendant] has made." Id. at 409, citing *Vervaecke v. Chiles, Heider & Co.,* 578 F.2d 713, 716-17 (8th Cir. 1978). Thus, when alleged omissions are really "in the nature of misrepresentations (misleading statements, half-truths)," reliance must be proven. *Vervaecke,* 578 F.2d at 717 n.2. *Accord, Wilson v. Comtech Communications Corp.,* 648 F.2d 88,93-94 (2d Cir. 1981); *Lorber v. Beebe,* 407 F.Supp. 279, 289 (S.D.N.Y. 1975).

The implications of this case authority for the present lawsuit are as follows. Maremont was under no obligation to disclose the possibility of a tender offer or the existence of the FTC consent decree absent statements which would be materially misleading without the disclosure of that additional information. In consequence, plaintiffs must prove reliance on the allegedly misleading statements—namely, that Maremont was purchasing only "up to" 20% of Pemcor, that it knew of no

"antitrust problems," and that it would make no tender offer—before damages can be awarded on an omission theory.

3. Reliance on Nonwritten Representations.

The third area of legal dispute between the parties centers on the application of the materiality rule to fully negotiated transactions such as the present one. At several portions of its post-trial brief, Maremont argues that the alleged misrepresentations were not material or that the Rowes could not have reasonably relied on them, because none of the misrepresentations were contained in the final written agreement, and because the Rowes through their attorney Fuchs certified to Pemcor that the written agreements were "the only agreements, instruments and understandings" between themselves and Maremont. (Ex. 57 p.2).

In *Contractor Utility Sales Co. v. Certain-Teed Products Corp.*, 638 F.2d 106 (7th Cir. 1981), plaintiff sales agent and defendant manufacturer engaged in two days of face-to-face negotiations during which defendant orally promised to keep plaintiff "competitive" in the rural water market. *Id.* at 1068. The final written sales agent agreement, however, did not contain this representation and did contain an integration clause. The Seventh Circuit rejected the position that as "a matter of law, it is unreasonable for any party to rely upon a prior oral representation when that party subsequently executes a negotiated written contract containing different representations and an integration clause disavowing any prior representation not incorporated in the written agreement" and held that the "reasonableness of [the plaintiff's] reliance is best decided by the jury which can weigh the various relevant factors such as: the prior relations of the parties, the frequency and nature of the representations, the conflict between the representations and the contract provisions, and the custom within the trade." *Id.* at 1083.

Certainly in many cases consideration of these factors would preclude reliance as a matter of law. In *Robinson v. Cupples Container Co.*, 513 F.2d 1274, 1277 (9th Cir. 1975); plaintiff claimed that the defendant purchaser of his business falsely promised to invest significant sums in expansion of his

old company's operation, Plaintiff admitted, however, that when the agreement was drafted months later, the company refused his request to put this representation in the written agreement. The trial court directed a verdict on the defendant's favor. The court of appeals found that no reasonable investor would have attached importance to the earlier representation under the circumstances of the later refusal, and affirmed.

In the present case, the letter agreement between Maremont and the Rowes contains no integration clause, nor any representation which contradicts the alleged misrepresentations based on which the Rowes now seek relief. Under these circumstances, even though both sides were represented by counsel, reliance remains an issue for the finder of fact. To the extent that Maremont argues reliance is vitiated as a matter of law, its argument is rejected. The Rowes' later certification that there were no private understandings between them and Maremont, and the Rowes' failure to insist on reducing the alleged misrepresentations to writing are, of course, nonetheless relevant in determining whether reliance and materiality have been proven.

4. Materiality of Preliminary Merger Discussions.

Maremont finally argues that as a matter of law, the Rowes' claims are insufficient to the extent that the Rowes seek relief for Maremont's failure to disclose the possibility of a tender offer. Maremont correctly argues, that for purposes of a pure nondisclosure case, a proposed merger transaction only becomes material once it has passed beyond the preliminary stage. *See Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S.Ct. 1189 (1985); *Reiss v. Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982); *S.E.C. v. Mize*, 615 F.2d 1046 (5th Cir.), *cert. denied*, 449 U.S. 901 (1980). As noted by the Seventh Circuit in *Michaels v. Michaels*, 767 F.2d 1185, 1195-96 (7th Cir. 1985), *cert. denied*, 106 S.Ct. 797 (1986), the policy underlying this rule is not that merger negotiations are unimportant to investors but that until price and structure are agreed upon the disclosure of a tentative

merger is likely to mislead the market. The rule is limited by its rationale to cases when there is a public market for the target's stock. *Id.* at 1196.

The facts are undisputed that Maremont still had not decided to make a tender offer for Pemcor as of the date of the Rowe transaction, and the above cases are therefore applicable. Nonetheless, the rule entitling an issuer to keep silent about preliminary merger negotiations does not logically extend to the situation where a duty to disclose arises from other affirmative misstatements of a party or its agents, *Levinson v. Basic, Inc.*, 786 F.2d at 748-49; *Etshokin v. Texasgulf, Inc.*, 612 F.Supp. 1212, 1217 (N.D. Ill. 1984). In the latter situation, the true gravamen of the injury is not nondisclosure but that the half-truth uttered was misleading under the circumstances. Thus, even though Maremont was under no duty to reveal its intentions regarding Pemcor, that privilege did not entitle Maremont's agents to make other affirmative statement about its intent which would tend to imply that no tender offer was being considered. As noted in *Levinson,* once the defendant made certain statements regarding the existence of merger discussions, "it assumed the legal duty to be truthful." 786 F.2d at 747. Moreover, because the possibility of a tender offer has a significant impact on a stock's value, affirmative misstatements regarding such a tender are material under the test of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). *See Levinson,* 786 F.2d at 748.

With these overall legal standards in mind, the court turns to the specific claims of the plaintiffs.

## MISREPRESENTATIONS AND OMISSIONS RE POSSIBLE TENDER OFFER

All the Rowe witnesses testified that Maremont never revealed to the Rowes that it wanted the Rowe block as a springboard in a tender offer or other control acquisition. The only evidence suggesting otherwise was Pirie's deposition testimony that he thought he made it clear that Maremont was preserving all future options (Pirie Dep. 106, 205), and a page from Fuchs' memorandum indicating that Pirie specifically said

that Maremont had made "no decisions" and wanted to retain "maximum flexibility." (Trial Ex. 137-A p.5). Neither Pirie nor anyone else from Maremont remembered specific remarks, however, and the statement regarding flexibility was apparently made in the context of discussing Maremont's possible desire to take the shares out of escrow before Pemcor issued an opinion letter. (Id.; Pirie Dep. 206). The court finds this evidence vague at best, and insufficient to outweigh the live, credible, consistent and contrary testimony of the Rowe witnesses. The court then addresses whether Maremont knowingly implied that no tender would occur so as to incur a duty of disclosure.

By far the most crucial of the representations is Maremont Treasurer Shapiro's negative response when asked by Temple whether Maremont was going to make a tender offer. Although this statement was made after the Rowes had committed to a $13 price, the statement was made while the documents were being negotiated and drafted. The evidence strongly suggests that Shaprio was informed about Maremont's possible course of action, and thus knew or must have known that his negative answer was misleading. The evidence is in sharp dispute, however, as to whether the statement was ever made, and, if made, whether it was relied upon. In particular, defendant contests the accuracy of Fuchs' and Temple's recollection since the exchange is nowhere mentioned in the August rescission letter nor the Rowes' cross-claim, was not mentioned in Fuchs' very detailed notes of the negotiations, and was not testified to by Fuchs at his deposition. Prior to trial, only Temple recalled the exchange and answer.

Despite the improbability that such a statement, once made, could have been ignored by Fuchs, the court found both Temple and Fuchs to be highly credible witnesses, and was never given the opportunity to gauge the credibility of the Maremont agents who were present at the transaction. Temple testified that not only was the statement made but that he reminded Fuchs about it shortly after the tender had been publicly announced. (Temple Tr. 929-33, 941-42). Fuchs corroborated the conversation, to his own embarrassment since it meant admitting that he forgot a crucial detail in the

preparatory stages of this litigation. Given the consistency and credibility of their testimony, the court finds it altogether improbable that both attorneys could have misremembered the exchange. Thus, only three conclusions are possible: either Fuchs and Temple are both lying; Fuchs lied to corroborate Temple, who simply misremembered; or the exchange occurred more or less along the lines testified to by Temple and Fuchs simply forgot until he became aware of Temple's deposition testimony. The court finds the latter possibility the most probable of the three.

Nonetheless, the failure to mention the statement in the rescission letter, complaint, or Exhibit 57, raises serious questions of reliance. Fuchs gave no explanation for why he forgot the statement. The most logical explanation however, is that he and the Rowes considered the statement unremarkable in that Maremont had already affirmatively represented that its intentions were only to purchase around twenty percent of Pemcor or whatever interest it took to elect a director to the board. The Rowes' concentration on the former statement is explained by the fact that neither of them knew about Temple's question, and Fuchs' concentration on the former may be chalked up to poor judgment.

While this explanation contradicts somewhat Fuchs' characterization of Shaprio's statement as "dramatic," the latter testimony is attributable to Fuchs' excitable way of narrating events. It is apparent to the court that the question and answer must have occurred in a side exchange, based on the fact that no other witnesses present, including Mr. Rowe, remembered it. (The court found credible Pirie's deposition testimony that he never heard this remark and never would have allowed it to be said without qualification.)

The evidence also shows beyond dispute that Teach told Mrs. Rowe that Maremont was purchasing the Rowe shares for investment, and that it wanted only enough shares to elect a director, which in turn meant around 20%. This testimony was not only consistent but was corroborated by the contemporaneous memoranda of the meeting prepared by Darryl Hoovel (Ex. 25) and by Fuchs. (Ex. 137-A). The court also finds

without much dispute that the plaintiffs genuinely interpreted Teach's remarks to indicate that Maremont's sole intention was to acquire an investment of around 20%. The court is particularly impressed by the facts that two bank officers with no financial interest in this case so interpreted Teach's remark, and that one of those officers immediately phoned Fuchs upon learning of the tender to complain that they'd been "taken." (Martin Tr. 439).

Whether the above statements were made with the intent to mislead is a more complicated question. In order to collect damages, the Rowes must prove that Maremont acted with scienter, i.e., either with the intent to deceive or with awareness that its statements created a danger of misleading others. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). Reckless conduct is actionable under 10b-5 where it is equivalent to "willful" fraud. *Id.*

This standard requires a statement-by-statement assessment on these facts, since at least some of the statements regarding "investment" purpose were made in the context of the "investment representations" required to satisfy the private placement exemption, i.e., that Maremont was not purchasing with a view to resale. Certainly, this is the meaning of the "investment representations" contained in the final agreement, and the court found plaintiffs' arguments to the contrary unpersuasive. Even if plaintiffs did so interpret the written agreement, the court finds that Maremont did not intend to represent anything about a tender offer through these statements.

The evidence also shows, however, that both Teach and Shapiro on separate occasions during the negotiations referred to "investment" as Maremont's motive in purchasing Pemcor stock, and not merely as an assurance that the sale was in eompliance with federal securities law. See, e.g., Trial Ex. 137-A at p.4 (Shapiro said he thought Pemcor was a "good investment"). Had Maremont been under an obligation to disclose control intentions, such statements would not have fairly alerted plaintiffs to the possibility of a merger or tender. See *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 713 (5th Cir. 1984). In this case, however, Maremont was

only under such a duty if its statements tended to imply that no tender would take place.

This court need not decide whether the mere invocation of vague investment motives thereby typically triggers a duty to disclose all intentions regarding merger. In this case, several of the statements regarding investment purpose were made in conjunction with a statement about electing a director to the Pemcor board, which appears to be without factual basis, and a statement, with only limited factual basis, that Maremont would purchase "up to" the percentage necessary for electing a director. The latter statement was not only made by Teach, but repeated by Penner and/or Shapiro when Temple was present. Both the repetition and the lack of factual basis bolster the plaintiffs' claim that the statement was intended as a smokescreen behind which Maremont could hide its true intentions. Significantly, no witness from Maremont ever testified to give an innocent explanation of either remark. Maremont's failure to produce its own employees as witnesses raises an inference that their testimony would not have been favorable to Maremont. *P.R. Mallory & Co. v. NLRB*, 400 F.2d 956, 959 (7th Cir. 1968), *cert. denied*, 394 U.S. 918 (1969).

The court is further struck by certain collateral misrepresentations which make sense only if one accepts plaintiffs' theory of events. First, both Teach and Shapiro represented Maremont's recent sale of a division and consequent cash on hand as reasons for the investment when these events were irrelevant to Maremont's interest in Pemcor. Second, Shapiro said that the Skadden, Arps lawyers were just "stopping by" as if to minimize the significance of Maremont not being represented by its usual attorneys, the Sonnenschein firm in Chicago. Third, Shapiro said that the cash would be wired in from California upon closing of the deal, in support of the story that sale proceeds were being reinvested, whereas Maremont in fact used its revolving credit from Continental to finance the purchase. The statements, although immaterial, persuade me that the statements regarding election of a director more likely than not were made as part of Maremont's attempt not only to keep silent about a possible tender but to create an impression

of limited intentions and thus prevent the subject from ever arising.

Finally, although again the evidence is susceptible of a different conclusion, the court finds that the plaintiffs have proven reliance and materiality. Mrs. Rowe refused to sell the stock "blind" without knowing Maremont's identity and something about its motives. The plaintiffs all genuinely believed Maremont was not going to make a control bid for Pemcor but simply hold a limited investment: again the court is struck by the banker Martin's testimony in particular. Hoovel, Martin, Fuchs, and Temple all further testified that they would have attempted to negotiate for some control premium had they considered a tender offer to be a possibility. (See, e.g., Martin Tr. 439-40). While the statements regarding 20% and electing a director arguably were immaterial in and of themselves, they were made in direct response to Mrs. Rowe's questions and were misleading because they failed to include the material factor that 20% was merely a "fallback" position and that Maremont's true goal was to merge with or acquire Pemcor.

Maremont argues that the Rowes were in fact unconcerned about what Maremont might do in the future with the Rowe block, and the written agreement's silence on the subject supports Maremont's argument. The Rowes' lack of concern, however, was predicated on their impression that Maremont had only limited intentions at the time of the purchase. The Rowes could have reasonably relied on this statement and considered it material without wanting to prevent Maremont from changing its mind in the future. What is important is that Mrs. Rowe questioned Teach about Maremont's intentions before agreeing to the sale or the $13 price. Thus, while it is unusual in a transaction of this kind not to include all material representations in writing, the Rowes' failure to put such matters into writing does not bar their recovery.

The court is admittedly troubled by the facts that Fuchs did not object after the tender offer was first announced but instead went forward with the deal, and that his notes of the August 15th conversation with Pirie reflect discussion of only the FTC problem. Martin, however, testified that he objected immediately and the Rowes themselves testified that they

wanted rescission right away but then consented to Fuchs' instruction to be cautious. The plaintiffs formally requested rescission about three weeks later, which is not an excessive period under most circumstances. The three-week delay in demanding rescission was primarily caused by the Rowes being in California and by attorneys from the D'Ancona & Pflaum firm being on vacation. That Fuchs may have misjudged the situation in advising excess caution and purporting to go forward in the interim, does not to the court's mind provide grounds for denying plaintiffs damages altogether.

Two other items could be seen as disproving reliance, and therefore merit brief discussions. First is Mills' testimony that at some point of the negotiations Temple asked him when (and not whether) Maremont was going to make a tender offer. The court found Mills a highly credible witness in that he freely admitted to thinking about the FTC order at the time Pirie represented a lack of antitrust problems. However, his testimony regarding this statement is questionable in that it did not come up at Mills' deposition and Mills remembered the question being asked at a time and place when Temple could not possibly have been there. Obviously, Temple could not both have asked the above question and have relied on the 20% statements as indicating an intent not to seek control. For this court to accept Mills's testimony would require finding that Temple lied on the stand. Based on all the evidence and the demeanor of the witnesses, I find it more likely that Mills either misheard or misremembered the question than that Temple could have lied.

Second is Anixter's testimony that he told Herbert Rowe on the 21st of July that Rowe's purchaser was probably planning a takeover, to which Rowe didn't reply. Rowe himself remembered responding that he had been advised there would only be a twenty percent purchase. Even accepting Anixter's version of events as more likely, however, Anixter's statement in and of itself would not necessarily give Rowe a reason for disbelieving Maremont's inconsistent representations. (As indicated in Rowe's August 1977 deposition, these representations were not made to him directly but communicated through his wife.) The negligence of a 10b-5 plaintiff cannot bar his

claim unless the plaintiff displays gross conduct amounting to a reckless disregard for the truth, such as when a plaintiff relies on certain oral statements despite express written warnings to the contrary. See *Teamsters Local 282 Pension Trust Fund v. Angelos,* 762 F.2d 522, 529-30 (7th Cir. 1985); *Zobrist v. Coal-X, Inc.,* 708 F.2d 1511, 1517 (10th Cir. 1983). Mere failure to "nose out" the truth does not defeat recovery.

In this case, the preponderance of the evidence suggests that Maremont never expressly said that a 20% investment was at best a fallback position; the only statements regarding Maremont's retaining flexibility were in connection with the escrow. That Anixter expressed a contrary opinion did not put on Rowe the legal duty to re-inquire of Maremont exactly what its intentions were. Moreover when Temple did inquire further into the possibility of a tender, he received a negative answer. Therefore, the court finds that Rowe's failure to heed Anixter's warning does not disprove reliance.

Maremont further argues that the Rowes' decision to press forward with their counterclaim contradicts their trial testimony of reliance. The court agrees with plaintiffs that to so hold would effectively and improperly penalize them for exercise of their right to make inconsistent pleadings under Fed.R.Civ.P. 8(e)(2). See *Continental Insurance Co. v. Sherman,* 439 F.2d 1294, 1298 (5th Cir 1971) (holding that one of two inconsistent pleas should not be used as evidence in the trial of the other). The Rowes were in doubt about how the FTC would resolve the dispute between Pemcor and Maremont, understandably sought to preserve their rights whichever way the FTC proceedings were resolved, and apparently relied on counsel in pressing forward with both claims. While the inconsistency here is admittedly unusual in that the Rowes' two claims sought contradictory relief instead of alternative grounds for the same relief, Maremont's argument is unpersuasive.

## MISREPRESENTATIONS AND OMISSIONS RE THE FTC DECREE

Maremont never made any representations regarding the existence of the FTC decree; the Rowes nonetheless argue in their brief that they requested and were entitled to know of all risks which could cause any delay in distributing the stock and the money. The court has searched the record for testimony that the Rowes expressly asked for such information, however, and has found none. Therefore, Maremont would only have been obliged to disclose the existence of the FTC order if disclosure was necessary to make other representations not materially misleading. Plaintiffs claim that two statements created such a duty: 1) Maremont's written representation in the final agreement that it knew of no circumstances or obligations likely to compel a disposition of the stock; and 2) Pirie's statement that he knew of no antitrust problems.

The plaintiffs' arguments on the former statement are without merit. Maremont's statement regarding disposition was made as part of the "investment representations" necessary for ensuring that the stock could be sold without violating the registration requirements of the securities laws. The term "dispositon" therefore can only reasonably be construed as referring to a market disposition or divestiture which would violate the 1933 Act. Even if the FTC had ordered Maremont to divest itself of the Pemcor shares, such sale and divestiture would not necessarily have rendered the Section 4(1) exemption from registration unavailable. (See Goldberger Tr. 1456). While with hindsight the Rowes obviously considered this statement misleading, the court finds no persuasive evidence that the statement was either intended or relied on at the time of the negotiation in the sense now claimed. Thus, if Maremont acquired a duty to disclose the FTC order's existence, it would only be by virtue of Pirie's statement that there were no antitrust problems involved in the purchase.

Pirie's statement was relied on by Fuchs, at least to the extent that Fuchs was willing to drop negotiations for a written guarantee on the basis of Pirie's opinion, even though Mills had refused to include a statement that no vertical integration

problems existed. The statement was arguably material in that antitrust problems could exacerbate the recognized danger that Pemcor might attempt to delay in issuing the opinion letter, although Fuchs never apparently advised anyone from Maremont that this was his reason for requesting such language in the initial draft, and did not mention Pirie's statement in the recission latter. Since the FTC order also presented a danger of delay, it too was arguably material. The court notes, however, that the delay eventually caused by the order —8 months—was far less than the initial two-year period the Rowes were willing to accept, and Fuchs did not insist on keeping the representation in writing. Thus the materiality factor was minimal at best.

Even assuming that Pirie's statement was materially misleading, however, the particular claim of nondisclosure would have to fail for lack of scienter. Contrary to Teach's and Shapiro's representations regarding Maremont's future intentions, Pirie's statement was not untrue, as the FTC's one paragraph approval of the transaction tends to show. More importantly, however, Pirie based his statement on the advice from the Sonnenschein firm that the decree would not apply. (Pirie Dep. 53). No outside lawyer ever told Maremont that the decree would apply or that Maremont should request prior FTC approval. (Black Dep. 225; Shapiro Dep. 219; Pelster Dep. 21-24, 51-53; Allard Dep. 32-33). In Pirie's words, the FTC decree to his mind was a "non-problem." (Pirie Dep. at 98). Although the Rowes have attempted to infer scienter from what they describe as an inadequate investigation, the evidence does not show that the investigation was in bad faith.

The Rowes concede in their reply that Pirie may have believed his statement, but argue that Mills certainly did not, and therefore that Maremont knowingly violated its duty of disclosure. Mills' excessive concern however, does not change the fact that he too had been advised by outside counsel that the order wouldn't apply, and apparently relied on that advice in not mentioning the FTC order to the Rowes. The court has had the opportunity to see Mr. Mills in person, found him to be a credible witness, and concludes that his silence on the FTC order in the face of Pirie's comment was neither reckless nor willful conduct such as would establish a 10b-5 violation.

## COMMON LAW FRAUD

Under Illinois law, a higher standard of proof than preponderance of the evidence is required to prove fraud; the plaintiff must prove all elements of the claim except reliance and injury by "clear and convincing evidence." *Gordon v. Dolin,* 105 Ill.App.3d 319, 324, 434 N.E.2d 341, 345 (1st Dist. 1982). As should be obvious from the delay in issuing this opinion, I did not find the plaintiffs' proof clear and convincing. There is some basis in the record for finding that Teach may have intended his remarks simply to refer to the ownership percentage which would result should all the Pemcor directors contacted by the Illinois Company decide to sell, and Fuchs' post-transaction conduct raises doubt as to whether Shapiro denied the existence of the tender offer. While I have found otherwise, I did so only after much deliberation.

The court notes, for purposes of appeal, that it would be in any event inclined not to award punitive damages in this case: the evidence of scienter, although sufficient, is thin, and some of the Maremont representatives—Pirie and Strom—assumed that the Rowes were aware of Maremont's true intent. Since the chief effect of upholding the common-law claim would be to allow a punitive award, my decision on the common-law claim is largely without significance.

## DAMAGES

Under @ 28(a) of the Securities Exchange Act, 15 U.S.C. @ 78bb(a), a defrauded seller of securities may not recover "a total amount in excess of his actual damages on account of the act complained of." The ordinary measure of such actual damages is out-of-pocket loss, or the difference between the fair value of what the plaintiff received and the fair value of what he would have received had there been no fraudulent conduct. *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 155 (1972). In certain situations, however, it is within the discretion of the court to apply a rescissory measure of damages. *Arrington v. Merrill Lynch, Pierce, Fenner & Smith,* 651 F.2d

615, 621 (9th Cir. 1981). The discretion as to which measure of damages is more appropriate in a given case belongs to the district judge. *Id.* at 621.

In *Affiliated Ute,* the Supreme Court indicated that one exception to the out-of-pocket measure arises "where the defendant received more than the seller's actual loss." In such cases, the Court stated, "damages are the amount of the defendant's profit." 406 U.S. at 155, citing *Janigan v. Taylor,* 344 F.2d 781, 786 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965). Because Maremont eventually made a profit on the Pemcor stock vastly in excess of any out-of-pocket loss the plaintiffs could reasonably claim, plaintiffs argue that disgorgement of profits is the proper measure of damages and ask for damages of $4,056,834, the profit realized by Maremont when it sold its Esmark shares in August 1979.

Although the literal language of *Affiliated Ute* encompasses this case, the rescissory measure of damages mentioned in that case "contemplates a return of the injured party to the position he occupied before he was induced by wrongful conduct to enter the transaction." *Nelson v. Serwold,* 576 F.2d 1332, 1339 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978). In other words, disgorgement of profits is appropriate only where the profits are "causally related" to the wrongdoing, *SEC v. MacDonald,* 699 F.2d 47, 54 (1st Cir. 1983), and the profits to be recovered must therefore be limited to those accretions which occurred up to a reasonable time after plaintiffs discovered the truth. *Id.* at 53.

Were this court to adopt a disgorgement measure of profits, the reasonable time within which the market accretions could be considered causally related to Maremont's wrongdoing would be not later than the date the escrow was distributed, or April 18, 1978, by which date Maremont had profited by a total of $1,902,115. After that date, the Rowes were free to reinvest their proceeds in Pemcor but chose not to do so. While trial counsel have argued that such reinvestment was impossible given the size of the block, the court finds no testimony that this was the fact or that this consideration was a factor in the plaintiffs' minds back in 1978. Therefore, if a

rescissory measure is appropriate, the correct disgorgement award would be $1,902,115.

Maremont, however, argues that disgorgement is inappropriate under the present circumstances since the Rowes were intending as of July 1977 to sell their interest in Pemcor regardless of its future profitability. As noted in *Capital Investments, Inc. v. Bank of Sturgeon Bay,* 430 F.Supp. 534 (E.D. Wis. 1977), *aff'd* 577 F.2d 745 (7th Cir. 1978):

> All of the decisions allowing rescisionary damages operate upon a common assumption: that profits, accruing after the sale to the fraudulent purchaser, would have accrued to the defrauded seller but for the fraud, i.e., the seller would have retained the securities. . . . [Where it is shown that the seller would not have retained the securities had full disclosure been made, there is no reason to allow the plaintiff accrued profits as damages.

*Id.* at 536. See also *Myzel v. Fields,* 386 F.2d 718, 745 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968) (jury instructed to consider before determining damages whether upon full disclosure plaintiffs would have still sold but at a higher price or would have retained stock).

It is of course impossible to turn back the clock and determine exactly what the Rowes would have done had Maremont revealed its intention to make a bid for all of Pemcor's stock. The Rowes themselves testified that they wouldn't have consummated the deal due to the controversy involved; the Rowes' lawyers and bankers testified that they would have negotiated for a higher premium on the price. It is evident, however, that the Rowes had unequivocally decided to sell "all or substantially all" of the Pemcor stock before Maremont contacted them, and had preliminarily committed themselves to a secondary offering of their stock. Plans for the offering were not canceled until after the Rowes had reached preliminary agreement with Maremont. Had the deal with Maremont not gone through, the most likely conclusion I can draw is that no tender would have been made at that time and

the Rowes would have proceeded with the offering, which in turn would have meant selling their shares at a considerable discount from the price received from Maremont. Based on the information in the record, not until June of 1978, after the Rowes had received the escrowed cash and long beyond the time a secondary offering would have required, would the Rowes have received more than $13 per share in a secondary offering.

The Rowes argue that although it is "speculative" what would have happened had they not sold to Maremont, "it is more appropriate to give the defrauded party the benefit of windfalls than to let the fraudulent party keep them." *Janigan v. Taylor,* 344 F.2d 781, 786 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965). The problem with this argument, however, is that it is not merely speculative what would have happened in this case: the evidence strongly suggests that the Rowes were eager to sell at the time they dealt with Maremont, were following advice of counsel (who would upon disclosure have negotiated for a premium), and thus would not have held onto their Pemcor stock in any event. Even with hindsight the Rowes made no attempt to purchase any Pemcor stock after they received the escrowed funds. The record also suggests that had the deal with Maremont not gone through, there would have been no tender offer and immediate rise in price at that time. Given this evidence, any damage award must be made on the theory not that the Rowes would have kept their stock in the event of full disclosure, but that they would have been able to sell at a price which fully reflected the value of the undisclosed information. The latter measure of damages, and not the profits Maremont subsequently made, most reasonably represents the "proximate consequence of the fraud." *Janigan,* 344 F.2d at 786. This is particularly true here because the subsequent price rise was primarily caused by bidders in the market for Pemcor other than Maremont.

According to Maremont, since the plaintiffs secondary offering would have yielded them less than $13 per share, the Rowes have suffered no damages at all. The court disagrees. The appropriate measure of damages in this case is the

traditional out-of-pocket measure of damages: the difference between the price received and the actual value of the stock, with the latter value determined by reference to the market reaction when Maremont publicly announced its tender offer. The court reaches this conclusion with some hesitation, since the parties have neither requested nor addressed such a measure. This court, however, is not limited in its role as a finder of fact by the plaintiffs' specific requests.

According to the record in the court, Maremont's purchase of the Rowe shares was publicly announced the same day that Pemcor announced a substantial improvement in earnings: the stock (which had been inching up the entire period of the Rowe Maremont negotiations) jumped over one point the next trading day to a high of 16.5. The stock then dropped to around 15, but climbed up again to 16.3 shortly after Maremont announced its tender offer. The stock price thereafter fluctuated and dropped below 16 until mid-November. Not until November 22, 1977 did the stock price again exceed 16.3.

There was no expert testimony at trial to explain how much of the rise in the market was due to Pemcor's increased performance and how much to Maremont's acts. At one point of the trial, I indicated that in the absence of such testimony I might charge Maremont with the actual market price if it were found quilty of wrongdoing. (Tr. 897). The high in the market after Maremont announced its tender was 16.3; by the market's evaluation of the undisclosed information, the Rowes were thus induced to accept a sale price 3.3 points below the actual value of their stock. This price, ironically enough, is close to (but slightly higher than) the 25% figure Fuchs testified he would have sought as a control premium had he known all material facts. (Fuchs Tr. 1135). There was no evidence to suggest that the Rowe block was worth more as a toehold to Maremont than the rest of the stock, especially since the shares could not be resold on the open market. The court therefore accepts 3.3 as the most appropriate per share measure of damages. Multiplying 3.3 times the Rowe shares sold to Maremont (the 216,965 owned by the trust and the 8,921 owned by the Rowes individually) yield a figure of $745,423.80.

The court denies plaintiffs' request for attorneys' fees as unauthorized by the federal securities law statutes. The court agrees with plaintiffs, however, that prejudgment interest should be awarded to make them whole for their loss and that the Illinois post-judgment interest statute provides a proper guide for determining the rate. See *Cant v. Becker,* 379 F.Supp. 972, 974-75 (N.D. Ill. 1974). Under Ill.Rev.Stat., ch. 110, @ 2-1303, the interest rate is 9% compounded annually. Because the court awarded out-of-pocket damages and not disgorgement damages, interest should be computed from July 22, 1977, the day the Maremont funds first went into escrow to be reinvested for the Rowes' benefit.

## CONCLUSION

Accordingly, the court enters the aforementioned findings of fact and conclusions of law under Fed.R.Civ.P. 52(a). The clerk is directed to enter judgment for the plaintiffs and against the defendant in the amount of $745,423.80 with interest of 9% compounded annually from July 22, 1977 up to the date this judgment is docketed.

It is so ordered.

Susan Getzendanner United States District Judge

## ORDER

IT IS ORDERED AND ADJUDGED that judgment is entered in favor of the plaintiffs and against the defendant in the amount of $745,423.80 with interest of 9% compounded annually from July 22, 1977 up to the date this judgment is docketed. Enter judgment.

## PROOF OF SERVICE

I, STEVEN M. STEINGARD, hereby certify that three copies of the foregoing Petition for Writ of Certiorari with Appendix has been mailed, postage prepaid to the following counsel this day of February, 1987:

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STEVEN M. STEINGARD

Supreme Court, U.S.
FILED
MAR 13 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1307

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

WINDON THIRD OIL AND GAS DRILLING PARTNERSHIP, et al.,
*Plaintiffs-Petitioners*,

—v.—

FEDERAL DEPOSIT INSURANCE CORPORATION, et al.,
*Defendants*,

—and—

PEAT, MARWICK, MITCHELL & CO. and A. MARSHALL SNIPES,
*Defendants-Respondents*.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

## BRIEF IN OPPOSITION OF DEFENDANTS-RESPONDENTS PEAT, MARWICK, MITCHELL & CO. AND A. MARSHALL SNIPES

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## Question Presented

Whether the summary judgment dismissal of a Rule 10b-5 claim was correct when: the claim was based on a single telephone conversation with a bystander to securities transactions occurring 11, 14 and 21 months after the phone call, the courts below concluded that the alleged misrepresentations and omissions in the phone conversation were neither material nor relied upon, and those conclusions are not challenged by the petitioners?

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## BRIEF IN OPPOSITION OF DEFENDANTS-RESPONDENTS PEAT, MARWICK, MITCHELL & CO. AND A. MARSHALL SNIPES

### Statement

In October 1979 Robert Olson ("Olson") made an unsolicited telephone call to respondent A. Marshall Snipes ("Snipes"), an employee of respondent Peat, Marwick, Mitchell & Co. ("PMM"),[1] to inquire about Clifford Resources, Inc. ("CRI") and its principal, Hal Clifford. Olson had been given Snipes's name as a "personal reference" by CRI. Olson and Snipes had never spoken before

1 PMM is a partnership engaged in the practice of accountancy.

this conversation and did not speak again after it. PMM had not audited or reported upon any financial statement of CRI or made any written or oral representation concerning its financial condition.

Snipes is alleged to have told Olson during that telephone conversation that "he and the other PMM partners" in the firm's Oklahoma City office invested exclusively with CRI, that the PMM partners had invested $250,000 with Clifford personally, that CRI's oil reserves were worth several million dollars, and that CRI's monthly cash flow was approximately $45,000. Petitioners have never claimed that the conversation was part of the purchase or sale of any securities or that it touched upon the value or wisdom of investing in any securities. Nonetheless, petitioners charge that Snipes failed to disclose the following "facts" to Olson: that Snipes had loans from Penn Square Bank; that CRI had cash flow problems; that certain "partners of PMM had obtained loans from Penn Square Bank" supposedly "with the aid" of CRI; that CRI assisted those PMM partners in obtaining the loans "so that Penn Square would continue to make loans to CRI"; and that at some unspecified future time "PMM would gain additional fees from rendering accounting services to Penn Square."

The telephone call took place in October 1979. PMM became the auditor of Penn Square Bank in December 1981, more than two years later. Except for that one telephone call nothing is alleged which connects Snipes and PMM to any petitioner.

The first of the three partnership petitioners, Windon Third, was not formed until September 1, 1980, almost a year after the telephone conversation between Olson and Snipes; the others were formed even later, Windon Fourth on December 3, 1980 and Windon Fifth on July 16, 1981. The offering memorandum for each set forth information relevant to the offering and prominently advised prospective investors:

> "ANY INFORMATION OR REPRESENTATION OTHER THAN AS SET FORTH IN THIS MEMORANDUM HAS NOT BEEN AUTHORIZED AND MUST NOT BE RELIED UPON."

Each offering memorandum set forth the results of CRI's drilling activities in 1978, 1979 and 1980 and CRI's revenues and expenditures for those years and stated that these data were "based on the books and records of [CRI]". None of the offering memoranda mentioned PMM or Snipes or referred in any way to Snipes's alleged comments about CRI in the telephone conversation so many months earlier.

Each offering memorandum informed prospective investors that the particular Windon Partnership offered would be investing in undetermined and unspecified oil and gas properties. Each memorandum disclosed that before forming the first of the petitioner partnerships (Windon Third) the two general partners—Olson and James Weiss—had formed and managed two other partnerships that had invested in oil and gas properties drilled and operated by CRI. By the time they formed Windon Fifth in July 1981, Olson and Weiss had been working with CRI for nearly two years and had acquired interests in 42 wells under development by CRI.

In March 1983 petitioners brought suit against several defendants in the United States District Court for the Western District of Oklahoma. Petitioners did not allege that Snipes's alleged representations and omissions were the cause of any injury. Rather, the sole claims alleged against Snipes and PMM were for aiding and abetting a purported violation of Rule 10b-5 by CRI and for common law fraud. The only basis alleged for these claims was the lone "cold call" to Snipes in 1979.

Initially the district court dismissed petitioners' claims against Snipes and PMM for failure to allege the basic elements of a Rule 10b-5 claim, but granted leave to amend (A-29-

31, 32).[2] So instructed by the court, petitioners added further allegations to their complaint.

The district court then granted summary judgment in favor of Snipes and PMM upon the amended Rule 10b-5 claim and dismissed the common law claim for lack of subject matter jurisdiction (A-19). Accepting petitioners' allegations as true, the court held that the substance of the telephone call was not material (A-14-15), that petitioners' alleged reliance upon the call was not justifiable (A-16-17), and that no conceivable basis for aiding and abetting liability existed because there was no showing of "knowing participation" and "substantial assistance" by PMM and Snipes (A-18).

Bearing in mind this Court's recent articulations of the standard for deciding summary judgment,[3] the United States Court of Appeals for the Tenth Circuit affirmed the district court's findings that materiality and justifiable reliance could not be established as a matter of law. 805 F.2d 342, 347 (A-10). Pointing out that Rule 10b-5 is not a "general liability statute," the court of appeals necessarily ruled that Snipes's comments in his brief conversation with Olson were too remote in time and substance from any purchase or sale of securities to create liability under the statute. *Ibid.*

**Argument**

Positing a duty that has no application to the facts, petitioners contend that the court of appeals erred in affirming summary judgment in favor of Snipes and PMM. That contention is without merit. The court of appeals and the district court correctly applied settled principles of law, their decisions do not conflict with any rulings of this Court or of the other courts of appeals, and the case does

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2 The appendix to the petition is abbreviated throughout this brief as "A- ."

3 *Celotex Corp.* v. *Catrett*, 106 S. Ct. 2548 (1986); *Anderson* v. *Liberty Lobby, Inc.*, 106 S. Ct. 2505 (1986).

not present a single novel legal issue. Consideration of the case by this Court is unwarranted.[4]

1. This action is based entirely on one telephone call to an individual who was neither a buyer nor a seller in a securities transaction. Petitioners have not alleged or presented a single fact suggesting that the conversation was part of the buying or selling of the Windon partnership units. Nor have they alleged or presented evidence that Snipes made any representation about the value or soundness of investing in the Windon partnerships or about the value or soundness of any arrangements between any Windon partnership and CRI.

Against this background the court of appeals properly found that petitioners had failed to establish both that the alleged misrepresentations or omissions were material and that petitioners justifiably relied upon them. The court of appeals held that "the records, exhibits, and briefs" presented "no factual dispute cognizable within federal securities law." 805 F.2d at 343 (A-2). Accepting petitioners' allegations as true, the court proceeded to test those allegations against "the substantive terrain" of section 10(b), 15 U.S.C. § 78j(b) (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986): *i.e.*, "to have legal significance, the allegation must be material, made in connection with the purchase or sale of a security, and be one on which Windon reasonably relied." 805 F.2d at 347 (A-9).

Even after resolving all inferences in petitioners' favor, the court of appeals found that they had failed to establish "the legal element of justifiable reliance." 805 F.2d at 347 (A-10). Pointing to the "brief telephone encounter" that

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4 As an additional ground for granting summary judgment in favor of respondents, the district court held that the amended complaint and supporting documents presented "no conceivable basis for aiding and abetting liability, either as to Peat Marwick . . . or as to Snipes and Peat Marwick jointly" because of petitioners' failure to show "knowing participation" and "substantial assistance" (A-18). Petitioners did not appeal from that ruling to the court of appeals and do not challenge it here.

forms the basis of petitioners' claim, the court found that "the record raises no inference of a relationship between Mr. Olson and Mr. Snipes which would provide a basis for a conclusion that Mr. Olson reasonably relied on his conversation with Mr. Snipes. To insinuate more into the Snipes-Olson communication would transform Rule 10b-5 into a general liability statute." *Ibid.* The district court had reached the identical conclusion, finding that the "disclaimers and caveats" in the offering memoranda "belie plaintiffs' claims that any of its partners or the partnership itself could have relied on Snipes' comments" (A-16-17).

Also unexceptionable is the Tenth Circuit's finding that Snipes's alleged misrepresentations or omissions were "remote and tangential" given the "nonexistence of a relationship" between Olson and Snipes. 805 F.2d at 347 (A-10). That finding implicitly recognizes that Snipes's alleged remarks about CRI were utterly insignificant when viewed against the "total mix" of information available to the petitioners, including CRI's books and records and the prior Windon partnerships' past dealings with CRI. *See TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976).

2. Despite petitioners' contentions to the contrary (petition at 5, 9) the finding of the court of appeals that "the record raises no inference of a relationship" sufficient to support a duty to disclose is neither anomalous nor a divergence from settled law. None of the cases cited by petitioners finds such a duty in a relationship as attenuated, casual and fleeting as the one brief telephone call between Olson and Snipes eleven months before the first petitioner-partnership was formed. For example, *First Virginia Bankshares* v. *Benson*, 559 F.2d 1307 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978), petitioners' main hope, involved discussions between representatives of two lending organizations about the credit-worthiness of a company. The defendant had periodically examined the company's books and knew it was for sale, but misrepresented the company's financial situation to an individual whom de-

fendant's representative personally knew to be the foremost broker of such businesses. Emphasizing that the "inquiry was more than an ordinary credit inquiry" and that defendant had "superior knowledge of inside information" because of its access to the company's books, the court ruled that on those facts a jury could find that defendant had a duty to disclose. 559 F.2d at 1317. Here, by contrast, the petitioners had a longstanding business relationship with CRI and, as the offering memoranda disclosed, had access to CRI's books and records and substantial information about its finances.

Petitioners' other citations of "duty to disclose" language are also wrenched from contexts wholly different from the situation here. *See, e.g., Levinson* v. *Basic Inc.*, 786 F.2d 741 (6th Cir. 1986), *cert. granted*, 55 U.S.L.W. 3569 (U.S. Feb. 23, 1987) (No. 86-279) (material misrepresentations by merger target); *Rudolph* v. *Arthur Andersen & Co.*, 800 F.2d 1040 (11th Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3572 (U.S. Feb. 4, 1987) (No. 86-1274) (allegations that auditor permitted publication of its audit reports and statements in a private placement memorandum that it knew to be inaccurate state cause of action under Section 10(b) and Rule 10b-5; court notes that in these circumstances "the accountant's information is obviously superior to that of the investor," *id.* at 1044, but cautions that "we cannot say on the pleadings whether [the auditor] actually had a duty to disclose," *id.* at 1045).[5] The purported conflict between the circuit courts of appeals is illusory.

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5 Petitioners have not cited a single case imposing a duty of disclosure upon the recipient of a casual telephonic inquiry initiated by an informed inquirer. Most of their district court cases involve misrepresentations and omissions by purchasers or sellers of securities or their principals. *See* cases cited in petition at 5-9. In others the statements or omissions bore directly on the value of the securities in question. *Marrero* v. *Banco di Roma (Chicago)*, 487 F. Supp. 568, 575 (E.D. La.

The ruling of the court of appeals in this case is fully consistent with settled law. As this Court has stated, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Chiarella* v. *United States*, 445 U.S. 222, 234-35 (1980). No such duty existed here.

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1980) (defendant bank allegedly executed a fraudulent filing in violation of Regulation U to facilitate sale of a security); *Whitbread (US) Holdings, Inc.* v. *Baron Philippe de Rothschild*, 630 F. Supp. 972, 975 (S.D.N.Y. 1986) (defendants induced buyer to purchase a distributorship by falsely promising to maintain a business relationship after the purchase).

## Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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